Four Dollars

Winter 1988/89

# THE BROOKINGS REVIEW

*What President Bush Should Know About*

*The Budget Deficit  Living Standards*
*The International Economy*
*National Security  White House Organization*

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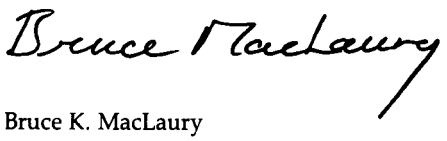
A newly elected administration faces a daunting array of tasks as it assumes office. Shifting gears from the heated rhetoric of campaigning to the formidable responsibilities of governing is a major challenge in itself. Finding enough talented people in the space of a few weeks to serve in top appointive posts would confound the most experienced search firms. And translating party principles and perceived election mandates into policy statements and legislative proposals before the traditional political honeymoon expires requires a focus and discipline that is exceedingly rare even in well-established organizations. These tasks are made all the more difficult by the nature of the central issues with which the president must contend: eliminating the budget deficit, restoring growth in American living standards, and ensuring international security in a rapidly changing world.

The counsel offered in this special edition of *The Brookings Review* represents the judgment of professionals who have been wrestling with the practical implications of these issues for some time. In the euphoria of an election victory, this advice may sound to some like a cold shower. We are fully aware that we are asking the president and his administration, as well as Congress, to make critical economic and political choices. We nevertheless believe that the next administration cannot and should not avoid the realities of the situation it will confront.

Readers who want to explore further some of the arguments set forth in this Review are urged to consult in particular two new Brookings publications: *American Living Standards: Threats and Challenges* and *Restructuring American Foreign Policy.* To those who will guide this nation over the next four years, we offer these thoughts in the hope that they will make the daunting job ahead somewhat more manageable.



Bruce K. MacLaury
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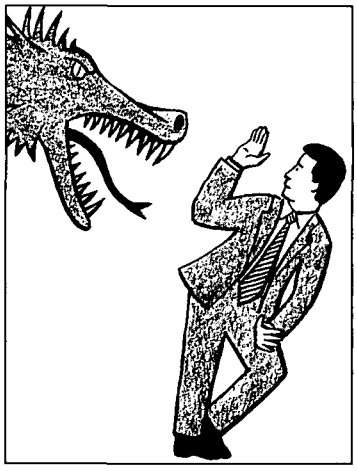
THE BROOKINGS REVIEW

Winter 1988/89 Vol. 7, No. 1



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*The Brookings Review* (ISSN 0745-1253) is published quarterly by the Brookings Institution, 1775 Massachusetts Ave., N.W., Washington, D.C. 20036. Second-class postage paid at Washington, D.C.
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Second class postage paid at Washington, D.C.
USPS I.D. No. 14209; Publication No. 551640.
Subscription rates:
one year $15 ($20 foreign);
two years $27 ($37 foreign).
Postmaster, send address changes to:
*The Brookings Review*
1775 Massachusetts Avenue, N.W.
Washington, D.C. 20036.
Circulation queries: (202) 797-6255
U.S. newsstand distribution by
Ingram Periodicals Inc.
347 Reedwood Drive, Nashville, Tenn. 37217


# Brookings Books

**American Living Standards: Threats and Challenges**
Robert E. Litan, Robert Z. Lawrence, and Charles L. Schultze, editors.
1988/$10.95 paper/$29.95 cloth

**Critical Choices**
Barry P. Bosworth and others. 1988/6.95 paper

**Restructuring American Foreign Policy**
John D. Steinbruner, editor. 1988/$10.95 paper/$29.95 cloth

**Organizing the Presidency**
**Revised Edition**
Stephen Hess. 1988/$10.95 paper/$28.95 cloth

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# Getting Rid of the Budget Deficit: Why We Should and How We Can

*Thomas E. Mann and Charles L. Schultze*

Almost as if by mutual agreement, both presidential nominees had little to say during the election campaign about how they would deal with the huge and persistent federal budget deficit and the fall in national saving and capital accumulation it has caused. Both George Bush and Michael Dukakis put forth what they described as "solutions" to the saving and deficit problem — Vice President Bush, a "flexible expenditure freeze," and Governor Dukakis, stricter enforcement of the tax laws. These plans, designed so they would not alienate any group of voters, are judged by most independent observers to be as ineffective as they are inoffensive. Moreover, since neither candidate apparently felt assured that his own approach to the deficit could withstand attack, little of the campaign debate centered on ways to eliminate the deficit.

We believe that the dearth of national saving and capital accumulation, and the budget deficits that are its principal cause, constitute America's most pressing economic problem. We hope that despite the paucity of campaign discussion about how to handle this problem, the new president will soon be of the same mind. And so we outline the reasons for our concern and offer several suggestions about how he might go about the essentially political task of securing public and congressional support for the measures needed to get rid of the deficit.

*Thomas E. Mann is director of the Brookings Governmental Studies program and former executive director of the American Political Science Association. Charles L. Schultze is director of the Brookings Economic Studies program and former chairman of the Council of Economic Advisers.*

## *Stability Is Not the Main Problem*

Traditionally, political debate about America's economic performance centers on questions of economic stability — unemployment, recession, and inflation. In these dimensions, the economy has performed quite well ever since the recession of 1981–82, despite the unprecedented increases in the U.S. budget and trade deficits and large swings in both interest and exchange rates. Given the high level of those deficits and the uncertain course of the dollar, preventing recession or a renewal of inflation — the two principal forms of instability — remains a major challenge. Nevertheless, with a little bit of luck and careful management of economic policy, especially by the Federal Reserve, the odds are reasonably good that both recession and worsening of inflation can be avoided *(see p. 23)*.

Recession and inflation, however, are not the only economic problems a nation faces. A successful economy must also make provision for the future. It ought not to consume, through either private or government spending, all of its current production. On the contrary, it should save a reasonable fraction of that income to invest in expanding the nation's productive wealth. The country's capital stock must increase simply to provide a growing labor force with an undiminished amount of capital per worker; otherwise the productivity of the labor force



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*Figure 1. U.S. Net National Saving*
*(as a percentage of net national product)*

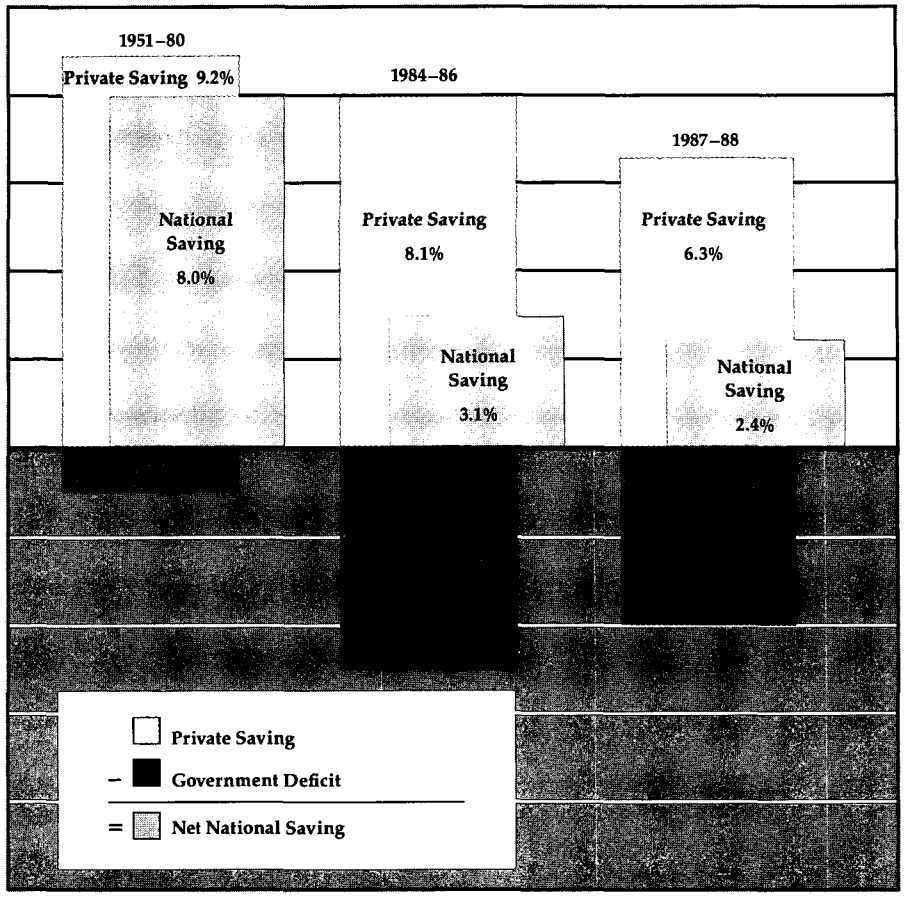
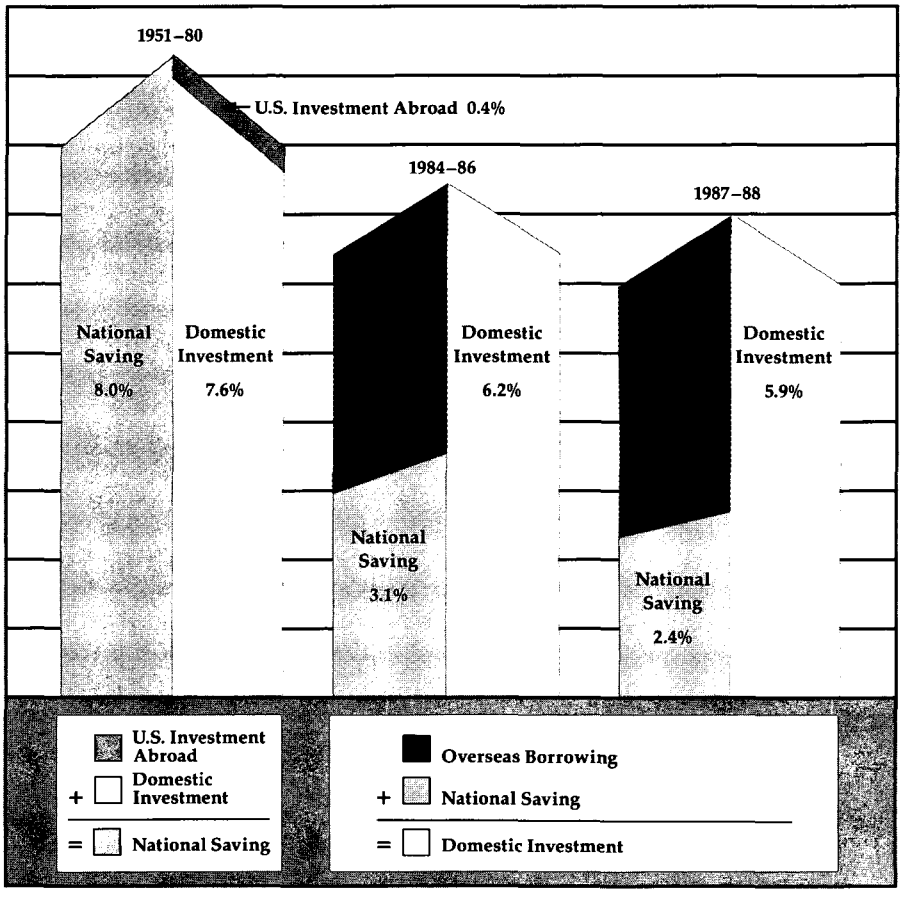



*Figure 2. Financing U.S. Domestic Investment*
*(as a percentage of net national product)*




Notes: 1988 data is for the first half of the year only. Surplus in state and local social insurance funds (mainly pension funds of state and local government employees) is classified as private saving.
Source: Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts.



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might actually decline. Further additions to the stock of national wealth are necessary to raise productivity and advance the nation's living standards. Because advances in technology are usually incorporated in the production process through the purchase of new machinery and equipment, a country that sharply cuts its rate of investment in new capital is also likely to stagnate technologically as the rest of the world moves forward. And if its citizens are to enjoy the fruits of capital accumulation, the United States needs to finance that accumulation out of its own saving, rather than borrowing heavily from abroad and paying interest and dividends to foreigners, as we have been doing recently.

With respect to this highly important aspect of economic performance — the national rate of saving and wealth accumulation — the United States has slipped backward considerably in recent years. It is to the difficult task of remedying this failing that the new president should give his immediate attention.

## *The Collapse of National Saving*

National saving consists of two major components — private saving and government saving. Government saving is the budget surplus. Conversely, a budget deficit *reduces* national saving, because an equivalent amount of private saving is diverted to finance the government deficit, leaving that much less available for national investment. The U.S. national saving rate has fallen dramatically in recent years, dropping from 8 percent of net national product during the first three decades of the postwar period to 3½ percent in the first half of the 1980s and to a mere 2½ percent in the last two years *(see figure 1)*. Both government and private saving declined. The private saving rate dropped by about three percentage points, to a low of 6 percent in 1987–88. And the government budget deficit, which represents national *dis*saving, rose from a 1951–80 average of slightly more than 1 percent of net national product to more than 5 percent in 1986, falling back to 4 percent in 1987–88 as some progress was made on the deficit.

The deficit grew for several reasons. The large tax cut of 1981 stimulated additional consumer spending, and the defense buildup of the early 1980s was not fully offset by cuts elsewhere in the budget. The deficit was further exacerbated by high real interest rates that had to be paid on the rapidly rising public debt. In short, throughout the 1980s, the United States has been on a spending spree, raising the proportion of its income devoted to private consumption and government spending and correspondingly decreasing the portion of income it saves for the future.

Had the United States relied on its own national saving, domestic investment would also have fallen to only a little more than 2 percent of net national product. But because of the high U.S. interest rates and foreign investors' assessment that the United States is a safe place to invest, it was able to finance much of its spending spree by borrowing from abroad on a grand scale, rather than by eliminating almost all investment here at home. Thus, domestic investment in housing construction and business plant and equipment fell by only two percentage points, despite a 5½ point decline in the national saving rate *(see figure 2)*. In the process, the United States, which in earlier years had generally been a net investor overseas, became a major net borrower in overseas markets.

The financing process worked as follows: the sharp increase in federal borrowing, added to the normal borrowing requirements of the private sector, drove up interest rates; the United States became an attractive place for foreign investors to put their money; the consequent increase in the demand for dollars raised the dollar's exchange value with other currencies, depressed American exports, and expanded imports. The net result was a huge trade deficit and a large inflow of foreign saving into the United States.

Foreign borrowing, however, will not allow the United States to escape the consequences of the drop in its national saving rate. Had the United States adjusted to that lower saving rate by radically cutting domestic investment in productive assets, the future growth of American living standards would have been depressed by slowing productivity growth. Having adjusted to lower saving by borrowing from abroad, U.S. living standards will suffer for a different reason — a continuing portion of our future income will go to foreign investors in the form of interest payments on the massive overseas debts.

## *The President's Choices*

The overspending by consumers and government continues. The new president faces the task of deciding what to do about it. With the dollar still well below the highs it reached several years ago, U.S. exports are booming and the U.S. trade deficit is declining. Correspondingly the inflow of foreign saving into the United States is shrinking. To keep the trade deficit moving down, the economy has to produce, within the limits of its slowly growing industrial capacity, more exports and more domestic substitutes for imports. To make room for that production without seriously overheating the economy, domestic demand must be reined in.

The president has only two real choices: he can reduce the budget deficit to slow down domestic spending and raise the national saving rate, or he can let the Federal Reserve curb spending through a restrictive monetary policy. If he opts for the first alternative, the growth of consumer spending could be reduced by a tax increase and the growth of government spending could be pared back. Interest rates would then fall, reflecting lower federal borrowing. Lower interest rates, in turn, would produce a lower overseas value for the dollar and hasten the decline of the trade deficit.

Because private saving has also fallen, eliminating the budget deficit alone would not return the national saving rate to pre-1980 levels, but it would go a long way in that



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direction. The American economy would begin to accumulate wealth again at a more normal pace, both because borrowing from overseas would diminish and because the rate of domestic investment would increase. The threat to the future growth of the nation's living standards represented by the abnormally low saving rates of the recent past would be, if not eliminated, at least substantially reduced.

The other alternative open to the new president is to pay only lip service to elimination of the budget deficit, abdicating to the Federal Reserve the task of cutting back the excessive growth of spending through tight money and high interest rates. Indeed, the inflationary threat from excess spending forced the Federal Reserve to begin the process of raising interest rates in the summer of 1987. That process was interrupted after the October stock market crash but resumed again in 1988.

A continuation of that process, however, would have three unwanted consequences. First, high interest rates depress investment spending more than consumer spending. Second, because they also tend to raise the value of the dollar, high interest rates would slow or even halt the decline in the U.S. trade deficit that is now under way, force the United States to continue its heavy reliance on borrowing from abroad, and thereby increase still further the already mounting burden of foreign debt service. Third, the necessity to pay higher interest on the public debt would increase government spending and exacerbate the deficit problem.

Thus, failure to use deficit reduction to slow the growth of domestic spending would perpetuate the nation's extremely low saving rate and the depressed rate of net capital accumulation that goes with it. The consequences will be highly unwelcome, but they may well not appear in the obvious and politically unpalatable form of recession or inflation. Instead, they will be much harder to discern, taking the form of a real, but year-by-year and almost imperceptible, slowing in the growth of American living standards. Therein, as we shall see, lies a major political problem.

## *The Size of the Deficit Problem*

Ideally national policy ought to aim not just for a balanced budget but for a surplus. America faces a long period in which the number of retired people will grow steadily relative to the size of the working population *(see box, p. 8)*. To avoid placing an undue burden on future generations, the current labor force should be saving for its later retirement, investing the funds in productive assets that will provide the extra income to support that retirement. The national saving rate therefore should be increasing, not decreasing.

### *The Social Security Factor*

Congress moved in 1978, and again in 1983, to restructure the nation's public retirement program, Social Security, so that the baby-boom generation of workers would in fact finance its own Social Security retirement benefits. The tax schedule was set high enough to ensure that the Social

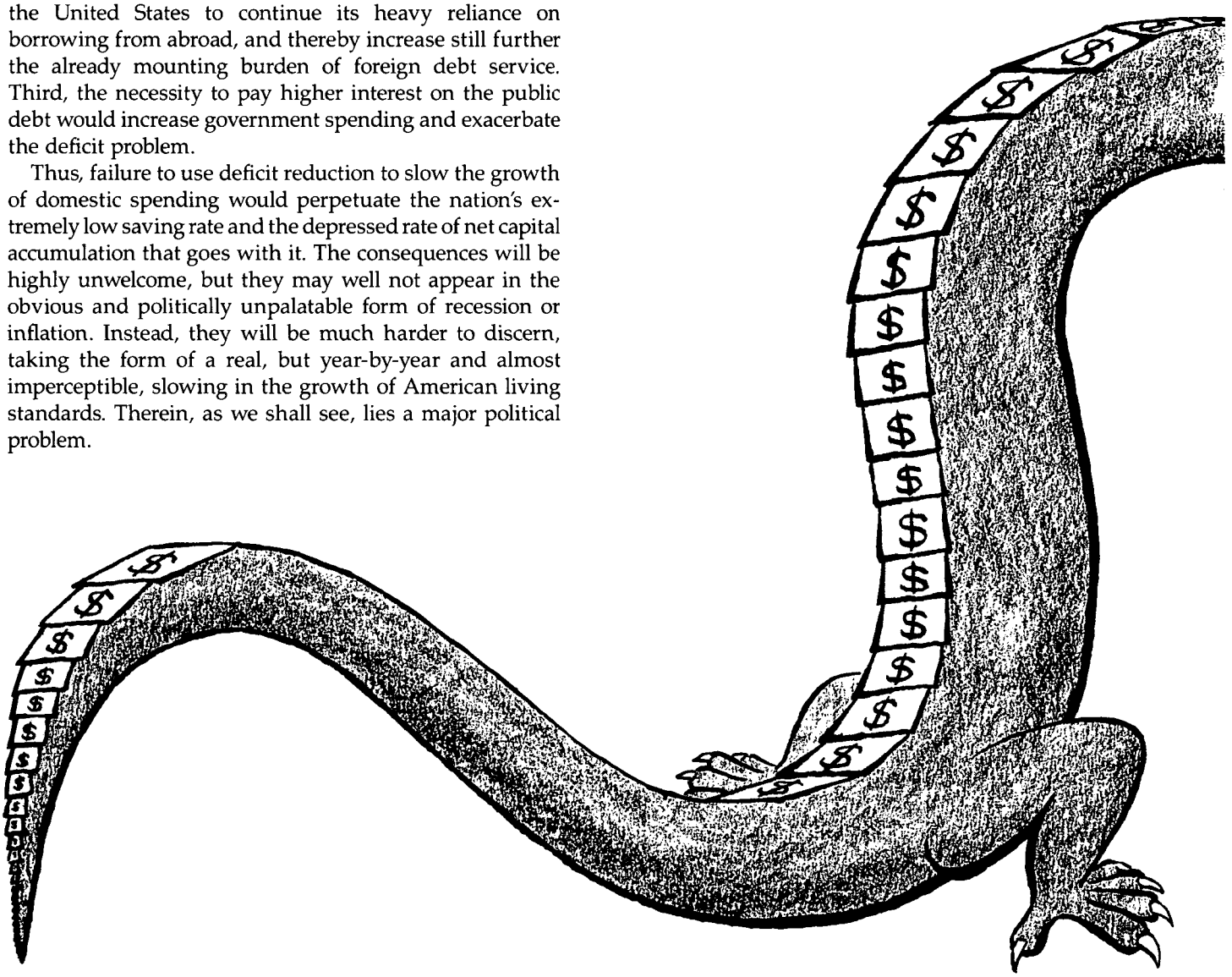

*Illustration by Robert Wiser*



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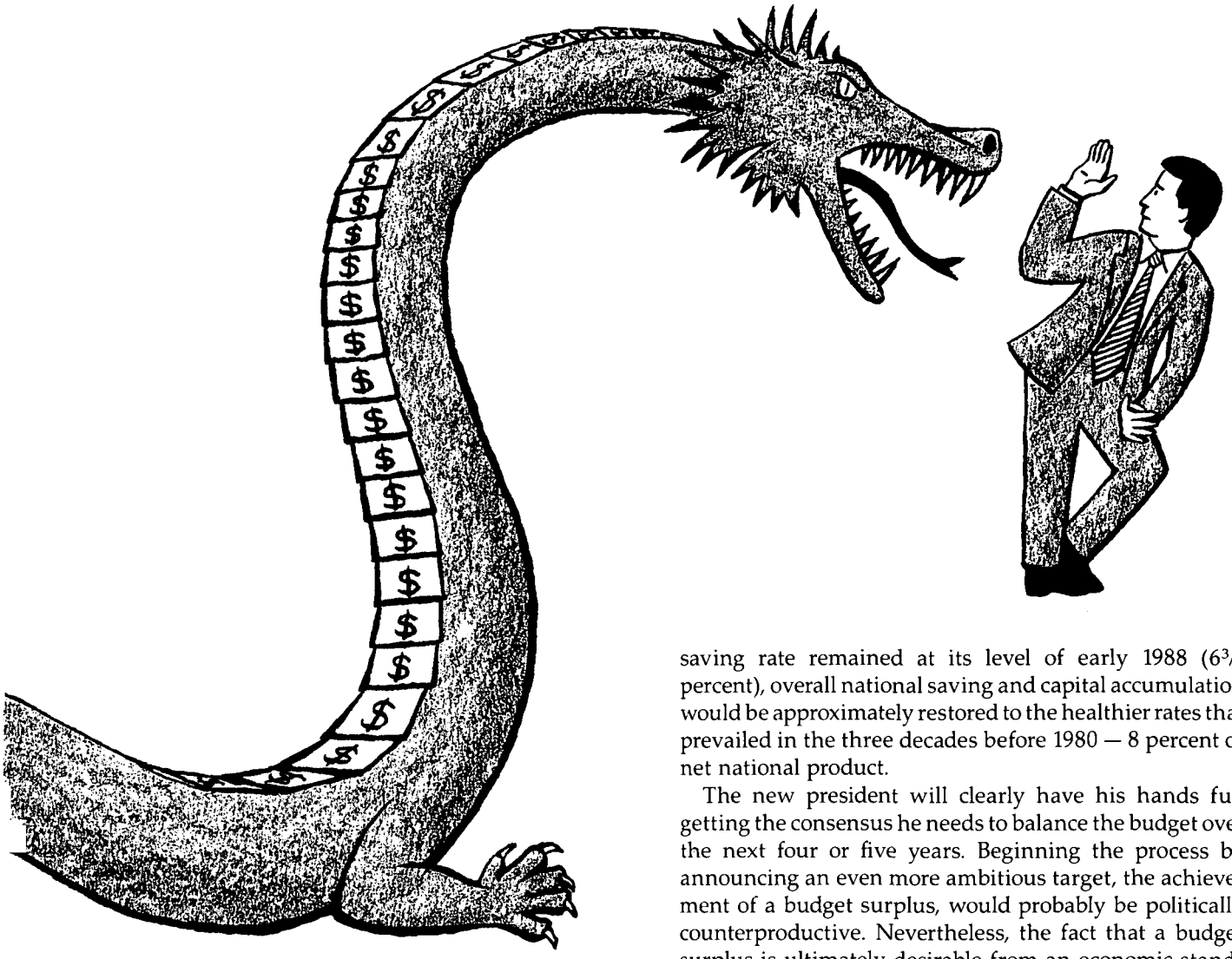

Security trust funds will run increasingly large annual surpluses through the rest of this century and into the next, to accumulate funds and invest in assets to help pay the benefits. In fiscal 1988 the trust funds had an excess of revenues over expenditures of some $40 billion; by 1993 that annual surplus will grow to about $100 billion.

The funds are invested in federal government securities. But the mere accumulation of federal securities in an earmarked trust fund does not itself help the nation accumulate additional productive assets for the future. To do that, the country must increase its national saving by an amount equal to the surplus in the Social Security trust funds. Accordingly, the federal budget, which as conventionally defined includes the Social Security funds, should in the long run aim at a *surplus* equal to the surplus in the Social Security funds. (Equivalently, the budget outside of Social Security ought to aim for long-run balance.)

Ideally, by the mid-1990s the federal budget ought to produce not merely balance but an overall surplus in the neighborhood of $100 billion a year, or about 1½ percent of GNP. If that goal could be achieved, while the private saving rate remained at its level of early 1988 (6¾ percent), overall national saving and capital accumulation would be approximately restored to the healthier rates that prevailed in the three decades before 1980 — 8 percent of net national product.

The new president will clearly have his hands full getting the consensus he needs to balance the budget over the next four or five years. Beginning the process by announcing an even more ambitious target, the achievement of a budget surplus, would probably be politically counterproductive. Nevertheless, the fact that a budget surplus is ultimately desirable from an economic standpoint can provide a helpful argument for the president to counter those who say the country can live with the current deficit.

## *Projections Too Optimistic*

According to the latest estimates of the Congressional Budget Office (CBO), the budget deficit, which will run in the neighborhood of $150 billion this fiscal year, may fall to about $120 billion by 1993. This estimate is for a "current services" budget, which assumes that tax laws remain unchanged, that spending for defense and discretionary civilian programs increases only to the extent necessary to keep up with inflation, and that spending for entitlement programs such as Medicaid and veterans' benefits proceeds in accordance with laws already on the books. The CBO estimate also assumes, with modest optimism, that the economy grows at a steady rate of a little under 2½ percent a year without recession and that inflation remains near today's rate of about 4 percent a year. The CBO projection assumes that the unemployment rate creeps up gradually to 5.7 percent by 1993. The budget office uses this estimate, rather than a more ambitious level nearer 5 percent, because on the basis of historical experience, the economy



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cannot be expected to run year after year at its full potential. And so, the CBO argues, prudent estimates of further budget outcomes ought to allow, on average, for a small amount of slack. Because the overall budget includes the Social Security funds, the estimated 1993 budget deficit of $120 billion consists of a $100 billion *surplus* in the Social Security funds and a $220 billion *deficit* in the rest of the budget.

The CBO projection is too optimistic in two ways. First, CBO assumes a significant drop in interest rates (it expects, for example, that the rate on long-term Treasury securities will decline from its current level of almost 9 percent to 7.6 percent by 1994). But if future budget deficits are actually as high as $120 billion, inflation is at the assumed level of 4 percent, and the inflow of funds from abroad continues to shrink, interest rates are unlikely to be much if any lower than they are today. And each percentage point increase in interest rates above the level assumed by CBO eventually adds some $25 billion to the annual deficit estimate.

Second, Congress, under pressure to hold down the budget deficit, has for the last seven years kept civilian

## *How Social Security Affects the Deficit*

Social Security — Old Age, Survivors, and Disability Insurance — provides pensions to eligible workers who become disabled or retire and to their dependents and certain survivors. Workers acquire eligibility by employment in jobs subject to the payroll tax, currently 12.12 percent on earnings up to $45,000 a year, levied half on employees and half on employers. The tax rate is scheduled to rise to 12.4 percent in 1990. Current law provides for no further increase in payroll tax rates, although the wage base is increased annually in line with the rise in average earnings.

The Congressional Budget Office estimates that Social Security outlays for benefits and administrative expenses will total $203 billion in 1988, $39 billion less than projected revenues of $242 billion. That surplus is projected to swell to $113 billion by 1994 and to keep rising for many years.

In the late 1970s the Social Security trust funds faced serious deficits. The shortfall in 1980 was $1 billion, and experts projected huge deficits once the large baby-boom generation began to draw its retirement benefits starting around 2010. As a result, Congress in 1978 and again in 1983 restructured the payroll tax, setting it high enough to build up a large surplus in the trust funds over the next four decades.

This approach forces members of the baby-boom generation to pay in enough taxes to cover their own benefits. The economic objective of the surplus is to increase national saving, raise the rate of capital accumulation, and thereby boost the capacity of the economy so that future workers will not be made worse off when the proportion of beneficiaries to workers rises.

Under budget conventions, Social Security taxes and benefits are lumped together with all other receipts and outlays of the federal government. Thus, a *surplus* in the Social Security trust funds *reduces* the overall federal deficit. Far from adding to the growing federal budget deficits that have emerged since 1980, the Social Security system has counteracted even larger deficits on the rest of government operations *(see table).* The projected drop in the overall deficit occurs entirely because of the considerable rise in Social Security surpluses. Indeed, the deficit on other operations of government is projected to increase.

In short, Social Security is not part of the federal deficit problem. Cuts in benefits would be justified only if benefits are larger than is appropriate. Three arguments have been advanced to justify benefit cuts.

First, the elderly, long an economic underclass, have achieved approximate economic parity with younger Americans. Because averages conceal serious inequalities within each group, however, benefit reductions should not adversely affect particularly vulnerable segments. Furthermore, since the economic parity of the elderly is traceable in large measure to increased Social Security benefits, basing benefit cuts on the economic gains of the elderly would be self-contradictory.

Second, life expectancy has increased, suggesting to some that American workers should continue to work longer than has been customary. In fact, the average retirement age has been falling.

Third, Social Security benefits currently are treated far more favorably under the personal income tax than are other pension benefits.

Three classes of proposals for cutting Social Security benefits have been mentioned as possible components of a deficit reduction package.

*Cost-of-Living Adjustments.* COLAs could be suspended or capped. Temporary suspension of such adjustments is equivalent to an across-the-board cut in benefits for everyone, regardless of economic status. A one-year suspension would reduce benefits about $10 billion a year. Suspending the COLA only on benefits above a particular level would be difficult to administer.

Limiting the COLA to two percentage points below the inflation rate would reduce outlays about $8 billion in 1991, $23 billion in 1994, and more thereafter. Permanently limiting cost-of-living adjustments, for example, to the rate of inflation less 2 percent, is equivalent to revising the Social Security benefit formula from one that



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budget programs under considerable restraint. Funds for some functions of government have been squeezed to a level that probably ought not to be sustained — pollution control, investment and operating expenses for national parks and forests, and worker training programs are examples. And pressures for new or enlarged programs (or for tax breaks to support "social" objectives) are mounting. Among these are day care, a space station, health insurance for those who are neither eligible for Medicaid nor satisfactorily covered by employers, and renewed funding for public housing *(health insurance, see p. 32; housing, see p. 34).*

While the tendency will be to finance as many new initiatives as possible either with new sources of dedicated revenues or by mandating expenditures from private employers, some of these activities will have to be funded in ways that enlarge the deficit. The added budgetary costs will not be dramatic, but they are likely to be substantial — on the order of $10 billion–$15 billion a year. In addition, the costs of dealing with the problems of federally insured deposits in ailing savings and loan institutions, especially in the oil-dependent states of the Southwest, will run very

| Federal Budget (Billions of dollars) | 1980 | 1988 | 1994 | Change 1980–88 | Change 1988–94 |
|---|---|---|---|---|---|
| Balance including Social Security funds | $–74 | $–155 | $–121 | $–81 | $ 34 |
| Social Security funds | – 1 | 39 | 113 | 40 | 74 |
| Balance excluding Social Security funds | –73 | –194 | –234 | –121 | –40 |

Source: Numbers for 1980 are actual. Numbers for 1988 and 1994 are Congressional Budget Office baseline projections.

ensures recipients benefits of constant purchasing power throughout their lives to one that ensures them continually declining benefits the longer they live or remain disabled.

*The "Retirement Age."* Workers must reach the age of 65 before they are eligible for full Social Security benefits. Retirees may claim actuarially reduced benefits after reaching age 62, and most, in fact, do. Because of the actuarial reduction, the long-term cost of benefits for those who retire before age 65 approximates that of workers who claim unreduced benefits at age 65. Increasing the age at which workers become eligible for unreduced retirement benefits could lower outlays materially.

In 1983 Congress provided for a gradual increase in that age limit to 67 starting in 2003. That increase could begin sooner and the age could be increased beyond 67. While the long-run budgetary implications of such a change are large, the short-run effects are likely to be small, as Congress would be unlikely to begin such an increase immediately and would phase it in gradually.

As part of a deficit reduction package, large cuts in benefits raise a knotty dilemma. Social Security is financed by a payroll tax specifically set to cover projected benefits. The most recent actuarial projections indicate that Social Security is in "close actuarial balance," a term of art that means that revenues projected over the next 75 years are at least 95 percent of projected outlays.

As we have noted, current revenues greatly exceed current outlays. If benefits were to be cut significantly, the excess of current payroll taxes over current outlays would increase, and the system would be overfinanced, according to the projection methods now in use.

If payroll taxes were unchanged, the effect of benefit cuts would be to increase the degree to which Social Security surpluses offset deficits on other government operations. But payroll taxes are highly regressive because they exclude earnings over the wage ceiling, currently $45,000 annually, and few people would find this tax a fair way to pay for the general operations of government.

On the other hand, if payroll taxes were cut in line with benefit reductions, the changes would do nothing to reduce the overall deficit. Only if such cuts in payroll taxes made it possible to increase some other tax, such as the personal income tax, would a balanced reduction of Social Security benefits and taxes contribute to deficit reduction.

*Taxation of Benefits.* Currently, half of Social Security benefits are included in income subject to personal income tax to the extent that income exceeds $32,000 for couples and $25,000 for single persons. In contrast, all private pensions are subject to tax unless they represent the return of premiums paid out of after-tax income by the worker. Application of the same principle to Social Security would require repeal of the income thresholds and inclusion in taxable income of about 85 percent of all benefits. Such a change would boost revenues by about $15 billion in 1989.

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*Senior fellows* ***Henry J. Aaron, Barry P. Bosworth,*** *and* ***Gary Burtless*** *are the authors of the forthcoming Brookings book,* Can America Afford to Grow Old? Paying for Social Security.



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much higher than the current budget projections assume *(see p. 36)*. Large additional amounts of federal budgetary resources will be required. A conservative estimate of the 1993 budget deficit, in the absence of major actions to correct it, would be in the neighborhood of $140 billion to $150 billion. (Because the economy will be growing, a budget deficit that remains at about $150 billion will absorb a declining fraction of net national product. But if the rising surplus in the Social Security accounts is excluded, the deficit in the remainder of the budget, as a share of net national product, will fall only slightly, from 4.6 percent in 1988 to about 4.2 percent in 1993.)

### *Can Growth Eliminate the Deficit?*

The faster the growth of the economy, the faster the growth of federal revenues. The CBO projection assumes that the growth of national output averages a little under 2½ percent a year between now and 1993. Is it possible that this estimate is substantially too pessimistic and that with more expansive economic policies — especially an easier monetary policy by the Federal Reserve — economic growth could be speeded up enough to eliminate the deficit over the next four or five years?

There are two kinds of economic growth. When an economy has much unused capacity and a high unemployment rate, as is the case during and immediately after a recession, it can grow much faster than its long-run growth potential, simply by putting idle workers and factories back to work. Once the economy has recovered to the level of its practical capacity, however, output can grow only as fast as capacity expands. At that point, expansive monetary or fiscal policies that seek to stimulate the growth of national spending faster than the growth of capacity will generate inflationary pressures, as consumers, governments, exporters, and investors attempt to buy more goods than can be produced.

The U.S. economy is now approaching the practical limits of its existing capacity, or productive potential. Economists do not know at exactly what point falling unemployment begins to generate inflationary wage gains. But historical experience and the demographic characteristics of the current U.S. labor force suggest to many of them that inflation will go up if the rate is pushed below 5 percent. Similarly, the manufacturing industry is running at about 84 percent of capacity, modestly below levels that in the past have signaled rising industrial prices. Perhaps a little slack remains to be taken up, but the U.S. economy cannot be expected to grow for any sustained period significantly faster than the growth of its potential or capacity output.

The growth of an economy's potential output is determined by a combination of two factors: how fast the work force grows and the growth of output per worker. Over the next five years or so the U.S. labor force will grow a little less than 1½ percent a year, according to projections of the Bureau of Labor Statistics. Estimating the growth of productivity is a more difficult matter. Starting in the late 1960s output per worker, which had been rising at some 2½ percent a year, began to grow more slowly. A further slowdown occurred after 1973. And during the past eight years output per worker grew at an average of a little under 1 percent a year.

*". . . any effort, through an easy money policy, to stimulate growth of this magnitude would yield neither higher growth nor a balanced budget, but substantial inflation almost surely followed by recession."*

Despite extensive research on the causes of the decline in productivity growth, which also occurred in other industrial countries, only a small part of the drop can be explained. Since no one knows why productivity growth slowed, no one can be certain what it will do in the future. Nevertheless there is no basis for making budget plans on the assumption that after 15 years of slower growth, productivity will suddenly accelerate. As a consequence, most projections of the growth of U.S. economic potential estimate that output per worker will continue to grow a little under 1 percent a year for the next few years. Coupled with a labor force growing a little less than 1½ percent a year and with a small allowance for taking up the slight amount of slack remaining in the economy, that yields a projected GNP growth of a shade over 2½ percent, a little higher than the CBO estimate, but not much. Actually realizing such growth for the next five years, without interruptions, would itself be quite an accomplishment, and as the CBO points out, a prudent estimate based on historical experience would not be that optimistic.

The CBO projections, together with the other assumptions outlined here, would produce an estimated budget deficit of $140 billion–$150 billion in 1993. It would take five years of economic growth of at least a percentage point a year higher than the CBO projection to generate a balanced overall budget by that year. Such a sustained growth rate is well beyond the bounds of the possible, and



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any effort, through an easy money policy, to stimulate growth of this magnitude would yield neither higher growth nor a balanced budget, but substantial inflation almost surely followed by recession. The United States cannot grow its way out of the budget deficit.

## *What It Will Take to End the Deficit*

In analyzing the federal budget, it is convenient to break expenditures into four major components, whose estimated 1988 magnitudes are: defense, $293 billion; Social Security and Medicare, $299 billion; interest payments, $151 billion; and all other, $320 billion.

Interest payments on the debt cannot be reduced by act of Congress. Other budget cuts, however, do slow the growth of the national debt and in that way lower projected interest costs. Elimination of the budget deficit would tend to bring down interest rates, which would also lower budget outlays for interest. On the other hand, CBO projections that underlie the deficit estimates given here already assume some decline in interest rates, even though such a decline would be unlikely without substantial deficit reduction.

On balance, however, the president and Congress can count on some interest "bonus" from budget-cutting measures. Any combination of tax and expenditure measures that took effect gradually and by 1993 amounted to about $100 billion a year would provide an interest bonus of about $40 billion–$50 billion annually, enough to balance the overall budget. A more ambitious program of tax increases and expenditure cuts that amounted to $150 billion a year by 1995 would, because of the bonus, convert a $150 billion deficit into a *surplus* somewhere around $100 billion, still less than that year's expected surplus in the Social Security trust funds.

### *Possible Spending Cuts*

After several years of steep increases in defense spending, a consensus seems to have emerged recently among Republicans and Democrats in Congress that the inflation-adjusted level of defense spending ought to stay near current levels; the remaining debate centers on whether it should rise or fall a little each year. Barring a major breakthrough in negotiations with the Soviet Union on conventional force reductions, a major deficit-paring program might cut $15 billion, perhaps $25 billion, out of the Pentagon's budget by 1993, but not much more.

Neither of the two political parties seems at all inclined to reduce Social Security benefits. Even if they were, a benefit cut would simply increase the already large annual surpluses in the fund, an increase that would offset deficits elsewhere in the budget. Since Social Security is financed by a highly regressive payroll tax, it seems highly inequitable, and even more politically unpalatable, to use that tax to finance deficits in the general operations of the federal government.

Social Security beneficiaries do, however, receive very special tax treatment on their Social Security income. They pay taxes only on half of their benefits, and then only if their total income is above a certain level. The rationale for the 50 percent exclusion is that beneficiaries, during their working lives, already had paid federal income taxes on their own payroll contributions to the Social Security funds. In fact, however, the typical beneficiary during his or her working life will contribute in payroll taxes far less than 50 percent of the retirement benefits he or she ultimately receives.

If Social Security benefits were taxed the same as benefits under private contributory pension plans, only about 15 percent would be excluded from taxable income. If the Social Security exclusion were reduced to 15 percent and if the income threshold were removed, the revenue increase would amount to about $20 billion a year by 1993. Under this approach, and unlike suggestions for across-the-board benefit cuts, the contribution of retirees toward deficit reduction would be related to their income, and because of the way the tax system works, low-income elderly would be exempt. The proceeds from the tax should be put into general revenues to help reduce the deficit, and should not, as is now the case, be earmarked for the Social Security trust funds.

Several measures have been taken in recent years to try to slow the growth of hospital and physician charges under Medicare, and some contributions from elderly beneficiaries have been increased. Additional savings may indeed be possible here, but, again, they are unlikely to be large. Because the number of beneficiaries is increasing and because medical care costs are rising much faster than inflation, Medicare outlays are scheduled to rise from their 1988 level of $87 billion to almost $150 billion in 1993, some $40 billion more than a simple adjustment for inflation. Thus any attempt to hold Medicare expenditure growth to the rate of inflation, implicit in proposals to freeze overall outlays, would involve huge and politically unjustifiable cuts in services for elderly beneficiaries.

Measured by number of activities rather than dollars spent, the "all other" category covers most of what the federal government does. It runs the gamut from the financing of medical care for the poor (Medicaid), to operating the FBI, to fighting the drug war, to providing student loans. All of these activities and programs now amount to some $320 billion, less than a third of the total budget. Congress and the president have already made substantial cuts here. In 1966, before President Johnson's Great Society programs had really gotten underway, the all-other category was 6.3 percent of GNP. By 1980 it had risen to 9.5 percent of GNP. Since then it has been steadily whittled down to 6.7 percent, close to what it was before the expansion. Undoubtedly some further cuts could be negotiated in selected programs in this group. But because they constitute only one-third of the budget and their relative size has already been reduced to what it was 20 years ago, achieving budget balance from further cuts in these programs seems both politically infeasible and substantively questionable.



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# Tax Increases: Choosing Among Four Broad Options

Should the new president decide to seek an increase in taxes, he will be forced to choose from among four broad options.

## Option One

*Raise Income Tax Rates.* The Tax Reform Act of 1986 significantly broadened the personal and corporate income tax bases. As a result, small increases in rates yield considerable revenue. An increase of one percentage point in personal and corporate income tax rates would bring in about $24 billion in 1989. Increasing personal tax rates, currently 15 percent and 28 percent, to 18 percent and 31 percent would raise revenues by about $74 billion in 1990 and by $89 billion in 1993.

The chief argument for using this option to raise taxes is that the tax reform law significantly increased the fairness of the personal and corporate income tax bases. The chief argument against this option is that Congress would be forced to reexamine some 1986 decisions it might prefer not to revisit. The most important of these involves the preferential rate for long-term capital gains, which was abolished in 1986. A rate increase would intensify pressure either to restore this preference or to adjust for inflation, a proposal that Congress rejected in 1986.

## Option Two

*Broaden the Income Tax Base.* Despite the base-broadening of the 1986 act, large components of income still remain outside the personal and corporate tax bases. Adding them to the tax base would raise considerable revenue. The largest items and the additional revenues they would provide in 1989 are: exclusion from personal income tax of employer-financed fringe benefits other than pensions, $29.9 billion; individual deductions for non-business state and local taxes (other than property taxes), $17.3 billion; deductions for property taxes on owner-occupied housing, $10.4 billion; deductions for mortgage interest, $32.2 billion; and failure to tax unrealized capital gains at the death of the taxpayer, $4.5 billion. Taxing employer contributions to pensions would yield $15 billion a year.

In 1983 Congress authorized the taxation of half of Social Security benefits for single beneficiaries to the extent that their annual income exceeds $25,000 ($32,000 for couples). Increasing the proportion of such benefits to 85 percent (a proportion that would make taxation of Social Security benefits similar to that of private pensions) and elimination of the income thresholds would raise revenues by about $15 billion in 1989.

The chief argument for subjecting these items to tax is that each should be included in the tax base if the objective is a comprehensive income tax. The chief argument against these reforms is a political one. Congress has repeatedly rejected some of them and refused even to consider others.

## Need for New Taxes

A review of the possibilities for spending cuts thus reveals that while some further reductions are possible, a serious effort to eliminate the budget deficit must include sizable revenue increases. Of the $90 billion–$100 billion in deficit reduction actions estimated to be necessary for balancing the budget, it is unrealistic to expect that more than $25 billion–$35 billion in expenditure cuts could be enacted. That leaves a minimum requirement for some $55 billion–$75 billion in new taxes. Even larger increases would be required if the budget is to be balanced without relying on the Social Security surpluses.

Modest contributions to this total might come from increases in the "sin" taxes on tobacco and alcohol. But even a 50 percent increase in these taxes would bring in only about $6 billion. In theory, the base of the income tax might be broadened by removing some additional deductions and exemptions. But the country has just gone through a major tax reform and, in any event, the large deductions that remain — for residential housing and for state and local income taxes — benefit not only the "rich" but also the broad range of middle-class Americans. Thus picking up much revenue from this source is likely to have little political support.

Some people might prefer to try to generate most of the revenue from additional taxes on the rich. But it would be impossible to raise the amounts necessary without raising marginal tax rates so much as to impair incentives seriously. Moreover, large increases in tax rates at the upper end of the income scale would begin to generate pressures to recreate the special lower tax rate for capital gains; eliminating that special rate was a major accomplishment of the 1986 tax reform, and an important element in reducing tax shelters.

As noted, a relatively substantial revenue gain, as much as $20 billion a year, could be realized from reducing the income tax exclusion of Social Security benefits from 50 percent to 15 percent and eliminating the income threshold. Politically, the only conceivable way that might be done is in the context of an overall budget reduction plan under which every element of society, except the poor, shares the cost. Both budgetary analysis and political realism suggest that any feasible plan to eliminate the budget deficit will have to include a large increase in revenues from one or more of the following sources: a broad-based increase in income taxes; a tax on gasoline and perhaps other forms of



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Furthermore, proponents of existing law claim that each exclusion promotes some form of desirable behavior by the affected taxpayers. Should some reduction in Social Security benefits emerge as an essential component of a deficit reduction package, many commentators view increased taxation of Social Security benefits as the most equitable way to achieve that reduction.

### Option Three

*Impose a Broad Consumption Tax.* For at least a quarter of a century various groups have argued that the United States should adopt a broad consumption tax, similar to the value-added tax used throughout the European Community and in many other countries. Because of the administrative burden of introducing a new tax, most analysts agree that it should be enacted only if it is to be used to generate large amounts of revenue, perhaps $75 billion or more annually. A value-added tax imposed on all consumption would yield about $20 billion a percentage point in 1989, about $12 billion if food, housing, and medical care were untaxed.

### Option Four

*Increase Excise Taxes.* Increases in various excise taxes could generate added revenue, although not so much as the other options. Doubling excise taxes on all alcoholic beverages would yield about $4 billion in 1989. Tripling tobacco taxes would yield just under $6 billion. Several different taxes on the use of energy have been proposed. A 5 percent tax on all uses of energy would yield $14 billion a year. A $5-a-barrel tax on all petroleum consumption would yield $18 billion. The same tax limited to imported crude oil plus a $7.50-a-barrel tax on imported refined petroleum products would yield $7 billion. A tax of 10 cents a gallon on motor fuel would yield $10 billion.

The chief arguments for increases in taxes on alcohol and tobacco are that they would discourage consumption of harmful products and that inflation has sharply reduced real rates of tax. The arguments for taxation of energy, petroleum, or gasoline revolve around conservation and reduced dependency on foreign suppliers. Each of these taxes falls disproportionately on certain regions or groups. For this reason, fierce opposition in Congress comes from representatives of affected regions who allege that imposing uneven burdens is an unfair way to raise large amounts of revenue.

The president will have considerable choice among options if he wishes to raise a modest amount of revenue, say $25 billion to $50 billion. Small increases in income tax rates, modest increases in excises, and perhaps a modest broadening of the tax base could be easily combined to supply this amount of revenue. If the president should conclude that large revenue increases are necessary — say, $100 billion or more annually — fewer options are available. He would have to rely either on increases in the income tax rate or on a new broad consumption tax. He is unlikely to seek large amounts of revenue from base-broadening because of the entrenched opposition to each possible change. And increased excise taxes could supply no more than a minor fraction of the revenue sought.

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energy; and a new value-added tax, which is in effect a broad-based sales tax on consumer goods *(see box, p. 12).*

We do not attempt here to give an economic or political evaluation of these alternatives. But the central message is that a program to eliminate the budget deficit, and even more so, one that aims eventually to do it without relying on the Social Security surpluses, will have to include a package of tax increases that will be felt by a very wide range of the population — including the average taxpayer.

## The Political Challenge

The new president faces a formidable political challenge. While some economists and financial leaders have for years been warning that large budget deficits would lead to catastrophe, none has occurred, and the public is growing immune to scare talk. Although far from guaranteed, the United States may be able to continue with large budget deficits and national overspending for another presidential term. The costs of failing to deal with the budget deficit are no less real for all of that.

But, as we have spelled out, they are gradual in nature, involving an almost imperceptible slowing year by year in the growth of American living standards. Like the fat person who needs to go on a diet but who feels that one more high-calorie meal won't hurt, Americans may rightly feel that one more year of high deficits will not itself cause grave damages. But continue the overeating, and the overspending, and long-term damage mounts up.

Unfortunately, the American political system is not well suited to address this challenge. While no democratic government can easily impose immediate sacrifices on its populace for the sake of future gains, the division of authority and responsibility between the president and Congress makes that task especially formidable in this case. In times of crisis, the government can move with breathtaking speed to change national policy; it can be equally responsive in the face of an insistent, unified citizenry demanding action from its elected officials. But political and institutional forces make it almost impossible for government to embrace austerity measures over the opposition of the public and with no promise of immediate gain or avoidance of disaster.

Some argue quite convincingly that the problem is simply too intractable for the government to resolve, that the political obstacles to the fiscal policy recommended



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here make its adoption highly improbable. Consider those obstacles. The overarching reality is the gap between what the public apparently wants from its government and what it seems willing to pay. By most accounts, the public's demand for government services is rising rather than falling as the Reagan era draws to a close. Although they were careful to avoid specific commitments for large increases in outlays, both presidential candidates acknowledged during the 1988 election campaign that government would be asked to do more, not less, in the years ahead.

At the same time, there is no comparable support for an increase in taxes to finance those services. In 1987 the federal tax burden was 19.4 percent of national income, the same level as in 1980 and slightly higher than the norm in the previous two decades. By these standards, Americans have little reason to believe they are undertaxed. Yet the generous commitment of public funds to Social Security and Medicare and to the buildup of national defense, all of which enjoyed broad public support, combined with the rise in interest payments on the exploding national debt, has left us with substantially more government spending than that historical tax burden can support.

That the public strongly opposes closing the gap by raising taxes is no surprise. Public opinion polls have consistently demonstrated that fact. In fact, an asymmetry in public attitudes toward taxes and deficits normally makes it easier to avoid a revenue shortfall than to deal with one once it occurs. Citizens will forgo tax cuts to avoid a worsening deficit; they will not embrace a tax increase to undo an existing deficit. Before income taxes were indexed in 1985, politicians had the luxury of seeing revenues rise through bracket creep; they could raise tax dollars at the same time that they passed tax cuts. With that option no longer available, any increase in federal income taxes must be legislated explicitly and in opposition to the expressed wishes of the electorate. Setting aside the tax increases of 1982 and 1984, which primarily repealed provisions of the 1981 tax bill not yet fully in effect, the last peacetime increase in federal income taxes enacted by Congress was in 1932.

*"The overarching reality is the gap between what the public apparently wants from its government and what it seems willing to pay. By most accounts, the public's demand for government services is rising . . . ."*

The public's demand for at least the present level of government services and its opposition to increased taxes to pay for it is exacerbated by the pattern of party competition that has developed in recent years. Cutting taxes has become the touchstone of the modern Republican party; it is no exaggeration to say that low marginal tax rates may well be the most enduring political and substantive legacy of the Reagan presidency. Republicans who once preached balanced budgets and fiscal responsibility have cheerfully set aside their green eyeshades and embraced tax cuts as the engine of economic growth and opportunity.

Democrats, chastened by Ronald Reagan's effective use of the "tax and spend" charge and by Walter Mondale's failure to build support for a "responsible" tax increase in 1984, are eager to shed their identity as the party that raises taxes. The situation is exactly reversed on the issue of Social Security. The Democrats have hit paydirt in recent elections by portraying themselves as the champions of Social Security, repelling attacks on the system by the Republican party.

Each party is convinced that its greatest vulnerability is the other party's strength. Republicans feel especially vulnerable to charges that they are out to cut Social Security benefits, while Democrats fear being branded as the tax collectors of the welfare state. Consequently, Republican and Democratic officeholders feel obliged to innoculate themselves from these charges by taking irrevocable public positions in opposition to any tax increases or Social Security cuts. Over the past seven years this intensely partisan environment made efforts to reduce the deficit much more difficult.

The rhetoric of the 1988 presidential campaign was consistent with this pattern. George Bush exempted Social Security from his "flexible freeze" on federal expenditures and then flatly and unequivocally ruled out a tax increase. "I promise you, I'll not raise taxes as a first, second, or last resort," he said. That declaration was a reference to Michael Dukakis' assertion that he would raise taxes only if expenditure cuts and more rigorous tax enforcement failed to close the budget gap.

Each time the candidates addressed the deficit problem during the course of the campaign, they painted themselves further into a corner. Bush left no doubt that he would reject any recommendation for a tax increase that might be proposed by the National Economic Commission, the bipartisan body many politicians and economists hope will provide political cover for serious deficit reduction in 1989. While Dukakis did not rule out a tax increase if he found it absolutely necessary, his public posture during the campaign makes it difficult for him to embrace the revenue



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*"These political constraints should not be underestimated for even a moment. Yet several other developments may well improve prospects for the policies recommended here."*

package that we have argued is necessary. Notwithstanding Senator Pat Moynihan's "law of opposites" (once in office, presidents do things least expected of them, often things they had explicitly promised not to do), what presidential candidates say during the campaign has consequences for their initial legislative program.

This partisan posturing on taxes and Social Security, with members of both parties eager to avoid blame for imposing or supporting austerity measures, has especially telling effects when the Republicans control the White House while the Democrats retain their grip on the Congress. With neither party fully responsible or accountable for fiscal policy, the incentive to pass the buck, to blame the other party and branch of government for the failure to balance the budget, often proves irresistible. (Divided government does not always work this way. The Tax Reform Act of 1986 is a good example of how under the right conditions divided government can muster bipartisan support for major policy change.)

The final obstacle to a bold move to reduce the deficit in the new administration is the easing of pressure to do something about it. One of the best kept secrets of the Reagan years is that the politicians on Capitol Hill were much more concerned about the deficits than the public was. Once it became clear in 1982 that the deficit was growing out of control, literally feeding on itself because of soaring interest payments on the debt, Congress took a number of difficult steps to contain costs and raise revenues. The cumulative effect was to lower the 1986 deficit by $162 billion.

This rather extraordinary achievement was made possible by a genuine fear among members of both parties that the economy would collapse under the weight of exploding deficits. Now that powerful motivating force is no longer present. Both deficits and the federal debt are projected to decline as a percentage of total national income over the next five years. The economy has performed well in recent years despite the unprecedented deficits and, as we have argued, it is reasonable to assume that the economy will continue to perform well in the near future. The temptation to declare victory and withdraw is hard to resist.

### *Encouraging Signs*

These political constraints should not be underestimated for even a moment. Yet several other developments may well improve prospects for the policies recommended here. First, the public might be more accepting of a tax increase than a quick reading of the polls suggests. At the same time that it declares its opposition to increasing taxes to reduce the deficit, a majority of voters believes that the next administration will raise taxes. The uncertainty, even anxiety, that Americans feel about their future and their children's future is based partly on a nagging worry that today's success cannot be continued in the presence of a massive and growing national debt. Most citizens naturally favor lower taxes and prefer candidates who are not eager to raise them, but they also retain some old-fashioned views about balancing their accounts and providing opportunities, not burdens, to their children.

While it would be a mistake to declare the tax revolt of the late 1970s over, the context within which taxes are discussed today is vastly different from that of a decade ago. The burden of proof, to be sure, is still on those who would raise taxes to demonstrate that they will not discourage private investment and dampen economic growth, that they will make possible the provision of needed government services, that they are designed not to redistribute income but to improve the welfare of all citizens.

But even with those stringent requirements, governors and mayors across the country have been able to convince their constituents that tax increases can serve legitimate and desirable public purposes. Those experiences should provide a modicum of encouragement to a president who seeks to persuade the nation that the prospect of long-term gain justifies some immediate sacrifice.

Second, the utter exhaustion among the combatants in the seven-year deficit wars provides an opportunity for the new president. Deficit politics has commanded center stage throughout the Reagan administration; virtually all policy discussion has been fiscalized, with budgetary considerations overwhelming substantive ones. Members of Congress have been frustrated time and again when the fiscal rewards for politically painful budget cuts and revenue increases vanished overnight with revised economic and budget projections. When changes in the economy, especially in interest rates, had a greater effect on the budget than any efforts of their own, members of Congress were forced again and again to up the ante. Cutting programs and raising taxes in one year seemed only to feed the



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demand for more spending cuts and tax increases the next. Budget reduction became an unending exercise that pushed everything else in Congress aside, and the failure to deal decisively with the deficit became a tacit admission that Congress was unable to govern. The prospect of continuing this exercise through the next administration is downright appalling to most of the participants. A reasonable and credible deficit package — even one with a tax increase — would have more appeal than the obvious political considerations suggest.

Other signs also indicate that a president intent on eliminating the deficit would not receive an inhospitable reception on Capitol Hill. While members of Congress certainly prefer raising expenditures and cutting taxes, rather than the reverse, congressional decisions on taxes and spending are not simply the sum total of 535 individual preferences. Historically, Congress largely follows the president's lead on fiscal policy, seldom raising overall expenditures or cutting taxes much beyond what he proposes (although often reordering his budget priorities). At various points, Congress has devised new institutional mechanisms to restrain the natural impulses of its members.

In the current era, the congressional budget process (especially its reconciliation process), omnibus spending measures, and strengthened party leadership have given Congress the capacity to engage in high-level budget negotiations and ensure the agreements at those summits are then implemented. The success of Congress in raising revenues in 1982 and 1984 and restraining discretionary domestic spending suggests that these new centralized decisionmaking procedures are not mere paper tigers.

If these developments make a deficit reduction package more politically feasible in the 101st Congress, they also underscore the point that little will be accomplished unless the new president takes the lead. Unless he is convinced that these steps must be taken, nothing short of an economic crisis can lead to any significant change in fiscal policy. Given both the campaign rhetoric on taxes and spending and the absence of any clear connection between deficit reduction and economic stability or political success, it is not easy to see how the new president will arrive at this position. But if he does, as we think he should, we believe his strategy for achieving these ends must be finely calibrated to the political and institutional realities that await him.

Even assuming his willingness to tackle the job, the new president faces a dilemma in how to go about it. On the one hand, his public popularity and influence over Congress are likely to be greatest in the months immediately after inauguration. That suggests that he should emulate the "blitzkrieg" model of immediate policy change used so effectively by Franklin Roosevelt, Lyndon Johnson, and Ronald Reagan. But unlike them, the new president cannot base his program on his recent victory at the polls. Election mandates are inherently subjective — more the result of politicians successfully selling their interpretation of the results than an objective reading of public opinion. Yet both the lack of candor in the presidential campaign about the remedies needed to deal with inadequate national saving and the absence of sweeping changes in the congressional elections make it virtually impossible for the new president to claim public support for bold and decisive action on the deficit. He is constrained both in what he can propose so soon after the campaign and in what he can get out of Congress.

## *A Strategy for Consensus*

On the other hand, no modern president can afford to do nothing while he educates himself and the public on the nature of the challenge confronting the country. As Stephen Hess points out elsewhere in this issue, first impressions of presidents are often lasting ones — getting off to a fast start is essential for a successful first term and, most importantly, for reelection. Consequently, the new president must adopt a two-stage strategy. First, he should seek to win an early victory — a $35 billion down payment on deficit reduction that honestly meets the fiscal year 1990 Gramm-Rudman-Hollings target — that would give him some breathing room in which to position himself and prepare the public for the larger task. That down payment would itself have to include some tax increase, though conceivably made up of small bits and pieces along the lines President Reagan himself agreed to several times during his administration. The more substantial tax increase would await the second stage. In the second step — a year later — the president should propose a multistage deficit reduction plan that would, at a minimum, eliminate the remaining deficit by 1993.

No effort to eliminate the budget deficit over the next five years and eventually to build a surplus can succeed without providing some room for additional spending (or tax expenditures). The carrot as well as the stick will be needed to marshal support from the public and Congress to deal with the long-term problem of national saving. Where the additional monies should be spent (or revenues forgone) will properly be a matter of some contention. But the new president is well advised to plan on the government doing some new things as well as less of some old things.

In designing the second, and by far the larger, stage of deficit reduction that we have suggested, the administration should reach a "framework" agreement with congressional leaders on the numerical targets and the basic elements of the package (although not its details) before announcing any goals. Given the opportunities and incentives to avoid blame, care must be taken to keep the opposition party, individual members of Congress, and major interest groups from publicly disavowing the package when it is unveiled. The new administration may also find it desirable to seek bipartisan agreement before unveiling its plan to meet the 1990 Gramm-Rudman-Hollings target, the first stage of deficit reduction.

Finally, the new president must define the deficit reduction goals in a way that gives members of Congress



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some assurance that their political sacrifices will not be in vain if the economy performs less well in the short run than anticipated. Targets should be set for tax increases and expenditure cuts, and members of Congress should not be asked to approve more spending cuts and tax increases if a sluggish economy keeps the deficit from shrinking as rapidly as expected. Cooperation is likely only if an end to the deficit reduction game is in sight, which suggests that the long-range economic assumptions used to calibrate the budget plan should be realistic and not based on a "rosy scenario." The central players must not be asked for more, year by year. They must know what the game plan is and what they will be asked to do. In presenting his first-stage plan the new president should therefore be candid in letting Congress know that one more step will be forthcoming. He must also be credible in assuring the legislators that it will be the final step.

The challenge facing the leaders of the next administration is to convince the public and the political community to undertake some immediate sacrifices for the sake of future gains. To be successful, they will have to persuade their audience that the future gains are worth the current costs. Talking only of austerity, of reducing current consumption, is not likely to play well in Peoria or anywhere else in the country. The new president should sell his package by focusing on national saving and investment, economic growth and opportunity, competitiveness in world markets, and higher living standards for our children and grandchildren.

The deficit problem is primarily one of national saving and investment and the remedy must be sold largely in those terms. But presidents, members of Congress, and political parties must still build and maintain majority coalitions in the present. And so it is reasonable for them to look for some more immediate incentives to help lead their supporters in the desired direction. Providing some room for new governmental activity is essential.

We have one additional suggestion. In an era of adjustable-rate mortgages and home equity loans, the public is especially sensitive to increases in interest rates. The new president can reasonably and responsibly call for an implicit trade-off between fiscal and monetary policy — higher taxes and lower spending (producing a smaller deficit) will be rewarded with lower interest rates, certainly lower than they would be without the reduction in the deficit, and quite probably lower than they are now. The near certainty that the Federal Reserve would keep the contractionary effect of a tighter fiscal policy from slowing the economy would provide some immediate political payoff for what is a decidedly long-term job.

To sell a tax increase politically, the president and Congress will almost surely have to meet a final and difficult challenge. Numerous surveys have shown that Americans are willing to pay increased taxes for what they consider worthwhile purposes. In the case at hand, that means the public must be persuaded that a tax increase will be used to reduce the deficit, and thereby be an investment in the future, not a squandering of revenues now.

Simply earmarking a federal tax increase for deficit reduction would be a charade; so long as the higher revenues give the administration and Congress the leeway to spend more, new taxes will not reduce the deficit, whatever accounting fiction is used. To ensure public support, therefore, the president and Congress must provide credible assurance that any increased spending will not go beyond levels agreed upon in the deficit reduction package. There are no easy ways to make this guarantee, but several possibilities suggest themselves. The enactment of multiyear appropriations, which could be amended only by a two-thirds or three-fifths vote, might contribute to this end. Other procedural devices to "lock in" the initial spending agreements, and perhaps even to tie the tax increase to observance of those agreements, may need to be worked out.

Whatever the specific arrangements, two elements are essential: first, a decision by the new president to abandon his campaign rhetoric and tackle this country's most serious economic problem; and second, *a political* agreement between the president and Congress on the overall budget plan and its enforcement. While the 1987 budget summit disappointed many observers by failing to make greater progress on reducing the deficit, it did succeed in demonstrating that even under divided government a multiyear bargain between the two branches can be struck and implemented on Capitol Hill. It is to these new political tools, not the substantive disagreements that blocked more progress on the deficit, that the new president and Congress should look for the way out of the deficit.



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*Robert W. Crandall*

# *Regulatory Reform: Are We Ready for the Next Phase?*

Eight years ago the Reagan administration made regulatory reform (and "relief") one of the four pillars of its new economic policy. An executive order was drafted in the first few days, establishing a review and clearance procedure within the Office of Management and Budget (OMB) for all new regulations. The first Reagan regulatory czar, James C. Miller III (later to become OMB director), chose the nine-digit Zip Code as his initial target, promising to "Zap the Zip."

Today the nine-digit Zip Code is alive and well. Unfortunately, the same cannot be said for OMB's regulatory review process. A political target on Capitol Hill, it has been reduced to a pale shadow of what the Reagan administration, Miller, and Vice President George Bush — who headed the Regulatory Reform Task Force — had intended.

Surprisingly, the anti-government Reagan administration has been less successful than the Carter administration before it in reducing the scope of government regulation. Reagan has no airline, trucking, or even oil decontrol legislation to match Carter's. Indeed, during the presidential campaign, Bush seemed to shy away from deregulation, afraid that the current fears of unsafe airliners and rising environmental problems have restored the public's affection for the protection afforded by Big Brother.

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Is there nothing left to deregulate? Has the crusade against government intervention in business gone too far? The answer to both questions is a decisive "no." Nevertheless, regulatory reform is not likely to be a major element of the new president's program.

The reason is simple — most of the current regulatory issues involve health and safety. Because positions on these issues are more often driven by emotion than rational analysis, no politician or political appointee is eager to take on the advocates of more government in this domain. That is too bad, for much could be done to improve health and safety while reducing the economic burden of such regulation.

## *Deregulation Successes*

It is quite remarkable that deregulation has so quickly developed a bad name in the political arena. The effects of airline, trucking, and railroad deregulation have been very favorable to most Americans. No one doubts that airline fares are lower and service more abundant because of deregulation. Those who care to investigate can also determine that airline safety continues to improve, but the public has been led to believe the contrary proposition. Surface transportation has also been improved. Trucking and rail rates have fallen without any loss in the quality of service.

Perhaps the only deregulation "disaster" has been the liberalization of competition in banking without reform of deposit insurance. But this failure can hardly establish a rational economic or political case for re-regulating pricing or entry conditions in communications, financial, or transportation markets.

## *Health-Safety Regulation*

The real regulatory failures have been in the health-safety-environment area. While Congress was deregulating transportation and liberalizing financial regulation in the 1970s, it was adding to health and safety regulation at a dizzying pace. Legislation was enacted requiring thousands of detailed workplace safety standards and controls on the myriad sources of water and air pollutants. Congress required detailed review of all toxic substances and procedures for banning existing or new substances deemed to be especially threatening, mandated close federal supervision of thousands of solid-waste disposal sites, and ordered the clean-up of thousands of other hazardous dumps.

There is scant evidence that these ambitious health and safety regulatory programs, or the scores of others enacted during this period, have measurably reduced threats to human health. They have, however, been very expensive to both business and the government, and ultimately to con-

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sumers. Environmental, occupational safety, and highway safety regulations alone now cost more than $60 billion a year. Nonetheless, public concern over acid rain, smog, medical waste, and contaminated groundwater has led to new demands for more legislation.

Current proposals would track all medical waste through a massive federal program, establish standards for all emissions of hundreds of toxic air pollutants regardless of the degree of human exposure, and tax all electricity to pay for scrubbers on hundreds of utility smokestacks, even if less expensive control strategies are available. Unfortunately, many of the new legislative proposals simply repeat the errors of the past by prescribing detailed new regulations that cannot be implemented efficiently or effectively, if they can be implemented at all.

The Reagan administration chose to address the failures of health and safety regulation not by looking carefully at the underlying statutes and proposing simpler, market-oriented approaches to solving serious social problems, but by unleashing a few score of OMB bureaucrats on the entire federal regulatory system to slow the pace of new rules and to ensure that those that were imposed were efficient and sensible. That strategy served primarily to irritate Congress, which sharply curtailed OMB prerogatives in this area. The strategy also did not touch many of the inefficient health and safety regulations already on the books.

## *Efficient Alternatives*

If progress is to be made in these regulatory areas, the underlying statutes will have to be amended to allow regulators more efficient choices and to encourage market alternatives to regulation wherever possible. A few examples will illustrate the point.

Let's begin with acid rain. The Clean Air Act now requires tight controls on all new sources of sulfur oxides and oxides of nitrogen — the components of acid rain — but not on existing utility boilers. Moreover, utilities are not allowed simply to burn clean fuels. They must install complicated stack-gas scrubbers on new sources regardless of the quality of the coal they burn. As a result, utilities continue to pollute from old facilities whose lives have been artificially extended by the environmental regulators and from new boilers with malfunctioning scrubbers. Add to this the emotional attacks on nuclear power plants, and it is clear that an environmental problem has been created in no small part by "environmental" policy.

Obviously, a sane clean air policy would get rid of all biases against burning clean fuels, but few of the "environmentalists" in positions of power in Congress would support such a solution because it might pull a few thousand dirty-coal miners out of the ground into other pursuits. To save these jobs, these legislators would encourage the use of high-sulfur coal and tax all electricity created from fossil fuels to pay for expensive scrubbers on those plants using the high-sulfur coal. Thankfully, these proposals have not been enacted into law.

Or take the issue of toxic air pollutants. No one seriously believes that these pollutants pose major threats to human health. Even if they do, each of these pollutants should be regulated in proportion to the risk it creates. Instead, environmental zealots have pressed for uniform regulation of discharges of scores of these substances regardless of the number of people potentially exposed. The result is that nothing happens because of understandable political paralysis.

Another example may be found in the Occupational Safety and Health Act. Under this statute, the Occupational Safety and Health Administration must regulate any hazardous substance found in the workplace to the maximum degree feasible no matter how few people are exposed or how little their health is threatened. As John Mendeloff has shown in recent research, this absurd instruction has hamstrung OSHA during Democratic and Republican administrations alike. No one is going to approve a regulation that costs several hundred million dollars for each life saved when these resources could be used elsewhere with much greater effect. OSHA is therefore reluctant to even begin to regulate most substances that could be causing some risk to workers because if it begins, it must press the regulations to such an extreme that it invites a political reaction and interminable court challenges.

This last summer was hot. As a result, alarmists are projecting global warming and a worsening urban smog problem. Once again, the interventionists' argument is for more regulation on everything — from greater fuel efficiency for cars to emissions controls for all vehicles to land use regulation. None of these advocates suggests a much simpler solution — raise the tax on fossil fuels, including gasoline. For liberals, a fuel tax could help close the federal deficit. For conservatives, it could offset further income tax reductions, including those on capital gains.

Fuel efficiency rules and tighter emissions controls are not only inefficient, but they needlessly punish U.S. automobile manufacturers and increase the number of old cars on the road. Moreover, they provide a futher inducement to the Japanese to penetrate the U.S. market. A new administration intent on pursuing jobs *and* a cleaner environment would press for much higher gasoline taxes or a general fossil-fuel tax.

If the new president wants to eliminate a set of regulatory policies that is expensive and of limited effect, he will have to persuade the public that a less aggressive interventionism could work better and at less cost. He might begin by targeting a few of the more extreme regulations, proposing that they be replaced with more rational policies, including taxes or other marketlike incentives.

But because of the emotional reaction the president is likely to receive from a number of single-issue constituencies, he will not find it easy to move away from the detailed government health-safety-environmental regulations of the 1960s and 1970s. Moreover, it is safe to bet that the office of the regulatory czar in the next administration will continue to be in the same location — in the Old Executive Office Building at the most distant point from the Oval Office.



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*R. Kent Weaver*

# *Coming to Grips with Indexing*

The next president will find that he needs all the maneuvering room he can get in attempting to reduce the budget deficit. Indexing — the automatic adjustment for inflation in many income transfers and other federal programs — now restricts many of the specific deficit reduction options available to the president and Congress. But some steps can be taken to make indexing more compatible with the objective of lower deficits.

Some 100 federal programs are now indexed. The most important of these are annual cost-of-living increases in Social Security retirement and disability benefits. Food stamps, Supplemental Security Income, veterans' pensions, and civil service and military retirement also have indexed benefits; Aid to Families with Dependent Children does not. Several income transfer and social service programs also have indexed income eligibility limits.

Altogether, programs with some indexing provisions compose more than a third of federal outlays — close to half of outlays if one counts pay programs for federal employees, which have a looser form of indexing. Several revenue-producing programs, including personal income tax brackets, are also indexed.

Political conservatives originally pushed indexing in the late 1960s as a mechanism to control spending; they thought that automatic adjustments would reduce politicians' propensity to hand out benefit improvements that outpaced inflation. And in that period of low budget deficits, they were probably right.

Today, however, huge budget deficits mean that politicians would not be so likely to hand out real benefit increases. Without indexing, they might even allow inflation to erode the real value of benefits a little in some programs. But with indexing in place, politicians must vote openly to change the legislation if they want to cut Social Security or other indexed benefits.

Politicians are understandably reluctant to do this. Indeed, the issue of inflation adjustments in Social Security has been virtually excluded from serious public debate because no politician wants to take the lead and risk voters' wrath. Only in 1983, under the political cover provided by the blue-ribbon Social Security commission, was any change made in Social Security benefit indexing: a modest permanent cut in current retirees' benefits disguised as a six-month cost-of-living adjustment (COLA) delay.

Indexing has been cut in other federal programs as well. But many of these cuts involved obvious inequities (for example, elimination of semiannual COLAs in some programs, conforming them to the general pattern of annual inflation adjustments) or flawed indexing formulas. Most of the rest of the cuts were of a one-time or even temporary nature.

Once federal programs get indexed, they almost always stay indexed. Even the Gramm-Rudman-Hollings deficit reduction mechanism protects individual income tax brackets and most of the large indexed income transfer programs from indexing cuts.

Proposals to change indexing range from changes in specific program formulas to a one-year across-the-board COLA freeze to the complete elimination of COLAs. The last of these ideas is clearly in the realm of fantasy. Any politician who proposed getting rid of all COLAs would be committing political suicide.

In any event, it is not entirely clear what effect such a change would have. Eliminating COLAs would lead to lower expenditures in the long run only if pressures to cut the deficit overwhelmed pressures to increase benefits on an ad hoc basis. Deficit reduction pressures might dominate in programs that serve politically weak or unorganized groups, but it is far from clear that a majority in Congress would opt for deficit reduction over benefit increases in a program like Social Security.

The one-year across-the-board freeze has some merits, but it too is politically difficult. The major stumbling block is the extreme political sensitivity of Social Security. And COLA freezes can also create new inequities. If Social Security COLAs are frozen for current recipients, for example, their benefits are lowered

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permanently. But individuals who retire the following year will not be affected, unless a change is also made in their initial benefit.

While proposals to eliminate indexing are unlikely to succeed, several steps can be taken to make indexation more compatible with deficit reduction goals.

One step would be to build additional discretion into non-means-tested entitlement programs, such as Social Security and civil service retirement. Congress could authorize the president to submit each year an alternative to the scheduled COLA, as he currently has the power to do with civil service and congressional pay. The alternative plan would become law unless Congress adopted an alternative. Although it would require a courageous president to use this provision to cut benefits — and a less courageous one would be tempted to use it to propose increases that outpaced inflation — it might give alternative adjustments a place on the agenda.

A second step would be to increase the use of indexing in tax and user charge programs. Many taxes, especially excise taxes on items like gasoline and cigarettes, are set not as a percentage of the price, but in specific dollar amounts. Manufacturers and consumers tend to resist tax increases, and thus tax yields usually lag behind inflation. Indexing taxes on these items would lower the political barriers to increasing revenue.

User charges for national parks, grazing rights, timberlands, and the like could also be indexed. Indexing need not be fully automatic, however. In programs where user charges are now set at a fixed amount, Congress could set a "zone of reasonableness" around the inflation rate. Program administrators would have discretion to raise prices within this zone. An administrator could forgo a price if he concluded that market conditions did not warrant it and if he reported his rationale to the Office of Management and Budget. Congress could overturn increases or make ad hoc changes, which would then alter the base from which the zone would be calculated. Price increases that administrators chose not to make in one year could be made later.

Critics may argue that indexing of revenue and user charge programs would artificially insulate the federal government from the effects of inflation. But that misses the point. Government is already sensitive to the political effects of inflation, as its reluctance to raise fees commensurate with inflation demonstrates. The reform proposed here would insulate policymakers from these political effects, allowing the increase to occur and making the public sector more, rather than less, comparable to the private sector.

A third step would be to increase the use of "contingent" triggers for reducing inflation adjustments. Such triggers would go into play only when a policy indicator reached a level specified by law. By relieving Congress of some of the blame for making cuts, contingent triggers make it somewhat easier to impose losses.

Several contingent mechanisms already exist. Social Security benefit increases, for example, are limited to the lower of wage or price increases if the Social Security trust fund drops to a specified level of reserves. Perhaps the most important contingent mechanism already in place is the Gramm-Rudman-Hollings deficit reduction procedure, which is triggered by projected levels of the federal deficit.

Several changes could make the Gramm-Rudman-Hollings statute a far more effective tool for deficit reduction, however. First, the automatic cutback provisions could be expanded to include non-means-tested entitlement programs, notably Social Security. While this provision would be extremely difficult to sell politically, the extent of the cutback could be limited, to a maximum of 1 percent below the full COLA, for example. Such a limit would make the cutback more tolerable, especially if it were included in a broader spending reduction package.

A second change would be to add certain revenue provisions to the Gramm-Rudman-Hollings process. The most appropriate starting point would be to make indexing of income tax brackets dependent on meeting deficit reduction targets, just as indexing mechanisms for some expenditure programs are (in theory) treated under current law. The personal exemption and standard deduction should continue to be fully indexed, however, to prevent tax increases for America's poorest citizens. Adjustment of tax brackets at a rate lower than inflation would then be part of a "three-legged stool," along with defense and domestic spending cuts, with each expected to contribute one-third of the required deficit reduction.

If, for example, bracket adjustments equal to one-half of the past year's inflation rate produced the necessary one-third of the deficit reduction, brackets would be set at that level. But tax brackets would be lowered no further than the previous year's level. If complete cancellation of bracket adjustments was insufficient to yield the complete one-third of deficit reduction, the remainder would have to be made up by expenditure cuts.

The concept of a contingent tax increase, as this in effect would be, is not a new one. In 1983 President Reagan proposed a 5 percent surcharge on federal income tax bills if deficits did not reach specified targets. Congressional leaders immediately rejected the idea, in part because the poor economic conditions at the time made a tax increase of any kind seem undesirable. But that rejection does not mean that the idea would fail under current conditions. Including revenues in the Gramm-Rudman-Hollings process might even improve the popularity of the process among Democratic lawmakers. Even better, it might prod policymakers of both parties to work toward an open compromise for deficit reduction.

In considering these and other proposals, policymakers and the public should acknowledge that a substantial degree of indexing in the federal budget is politically inevitable. The challenge will be to make indexing more compatible with more responsible policymaking and a more responsible fiscal policy and, wherever possible, to harness indexing to achieve those goals.



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# *Improving American Living Standards*

*Robert E. Litan, Robert Z. Lawrence, and Charles L. Schultze*

As a nation, the United States enjoys the highest living standards of any country on earth, a wealth and comfort that many Americans take almost for granted. For decades most Americans have assumed that their material lives would continue to improve and that their children would do even better. Now many fear that the nation is in serious danger of being unable to fulfill those expectations for a growing proportion of its population.

The key to growth in living standards is the rate at which productivity, or output per worker, rises. The faster the growth in productivity, the faster the growth in goods and services that each worker can afford to buy. From the end of World War II until 1973, productivity advanced by roughly 2 percent a year. Since then, the growth of American productivity and income per worker, which is closely related to productivity, has slowed to a crawl — growing at only 0.8 percent a year.

Eventually, slower growth in productivity and income means slower growth in living standards. When income growth for the average worker is rapid, as it was in the 1950s and 1960s, even those who fall behind in the economic race can still achieve absolute advances in living standards. But when the average rate of income growth is sluggish, as it has been for 15 years, many of the individuals, companies, and communities who fare worse than average will suffer absolute losses in their incomes and living standards.

On this evidence, one would expect Americans to be relatively gloomy about their own recent economic history. But public opinion surveys show just the opposite. That is because the United States has for a time succeeded in avoiding some of the decline in the growth of living standards that goes with a decline in productivity growth. It has done so in three ways. More women are working, giving families two earners rather than one. A greater share of income has been devoted to consumption — both private and public — rather than to investment. Net domestic investment in housing and business plant and equipment was 6 percent of national income in 1987, down from an average of 8 percent in the three decades from 1950 to 1980. Most important, the United States has resorted to massive borrowing from abroad. By 1987 the nation was spending 4 percent more than it produced, incurring an equivalent amount of overseas debt.

A nation can spend more than it produces — but not forever. Foreigners will not finance an unending spending spree; eventually the nation's spending must be brought into line with the country's productive potential and then reduced below that to pay interest and dividends to foreign lenders and investors. If the United States chooses to make the adjustment by cutting back investment spending, the growth of national productivity and industrial capacity

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*Illustration by Robert Wiser*



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will slow down. To avoid this outcome, the adjustment must be made by cutting back the growth of consumer and government spending. The United States will eventually pay the price for its recent overspending and underinvestment, but the long-run bill will be lower the sooner the necessary spending reductions are made.

The American economy, therefore, faces three challenges in the years immediately ahead. Will the United States take the politically difficult step of cutting back the growth of consumer and government spending so as to maintain the long-term health and growth of the economy? Can the nation manage an inflation-free transition toward a more balanced economy without plunging into recession? And how can it achieve faster productivity growth, both to cushion the short-term effects of the transition and to increase the long-run economic well-being of all Americans?

## *Transition Toward Balance*

As Thomas Mann and Charles Schultze point out in their article, the United States will have to bring total demand into line with growth in production in one way or another. Since the American economy is already operating at close to full capacity, further growth in export demand spurred by a lower dollar will boost inflation unless domestic spending is reduced. The days when the United States could hide the effects of its decline in productivity growth by massive borrowing from abroad are numbered.

The nation can bring its spending and production growth into balance in two ways. The new president can delegate the task of reining in domestic spending to the Federal Reserve, which can use high interest rates to restrain investment spending and to raise the value of the dollar, which in turn will slow the growth of export demand. Or he can mobilize Congress to eliminate the federal budget deficit, with cuts in government outlays and higher taxes that restrain consumer spending.

Choosing the first option would reduce domestic investment, impede or halt the decline in America's massive trade deficit, and divert a rising share of national output to pay interest on a steadily mounting pile of foreign debt. Choosing the second option — reduction of the budget deficit — would require Americans to make a temporary sacrifice in their living standards now in the interest of higher living standards in the future. Will that sacrifice mean that short-term living standards must actually fall, as some commentators have suggested? Or will it simply mean that living standards over the next few years will grow at a slower pace? In addition, whatever choice is made, can America break its overspending habit without falling victim to another recession?

One way to answer these questions is to project the effects that a policy of orderly deficit reduction would have on per capita consumer and government spending *(see table 1)*. The projections we have made assume that the budget deficit is reduced by $40 billion a year for four years. We also assume, in our "mid-range" projections, that output per worker rises 1 percent a year, that the labor force continues to grow faster than the population, and that the unemployment rate falls to 5 percent. That translates into a projected rise of 1.7 percent a year in per capita output over the eight years, compared with 1.2 percent between 1973 and 1987.

***Table 1. Historical and Projected Growth of National Output and Spending, 1950–95***

| Period | Output Per Capita | Government and Consumer Purchases Per Capita |
|---|---|---|
| Historical | | |
| 1950–73 | 2.1% | 2.1% |
| 1973–79 | 1.2 | 1.2 |
| 1979–87 | 1.2 | 1.8 |
| Projected | | |
| 1987–95 | 1.7 | 0.7 |

Sources: Department of Commerce, Bureau of Economic Analysis, and authors' calculations.

The projections further assume that the U.S. balance of payments deficit will decline to zero by 1995 and that the real exchange rate of the dollar will fall roughly 20 percent below its August 1988 level to ensure that result. If that occurs, then the merchandise trade deficit, which reached a record $160 billion in 1987, will eventually be converted into a modest surplus sufficient to cover the annual interest payments on overseas debt that the United States has accumulated during its borrowing binge. Finally, we assume that through some combination of tax increases and government spending restraints, the required reduction in the growth of national spending is made by consumers and government, not by lower investment spending.

On these assumptions, per capita spending by government and consumers combined can grow only 0.7 percent a year from 1987 through 1995, a positive rate of advance but one that nevertheless is much slower than at any time in the postwar period and only one-third the growth rate of the last seven years. Once the transition from overspending is completed, the per capita growth of national spending can rise again more or less in line with the growth in per capita output. If per capita output growth climbs to 1.7 percent, then after 1995 Americans will enjoy a rate of advance in their living standards considerably faster than in the 1970s but not as fast as in the 1950s and 1960s.

To look at these projections from a more personal perspective, if the economy expands between 1987 and 1995 at the projected rate, output per capita can grow by almost $2,300 (in 1987 dollars) over the eight-year period. But if international payments are to be balanced by 1995,



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then per capita spending — consumption and government purchases — will have to grow much less, about $900 over the eight years under our "mid-range" assumptions. The difference between growth in output and growth in spending would be devoted to other purposes: about $700 for extra growth in exports; $160 for interest on the foreign debt accumulated during the period; $120 for additional investment in domestic plant and equipment; and about $400 in losses in the nation's "terms of trade" (the decline in Americans' purchasing power due to the lower exchange value of the dollar required to balance international payments).

## *Risks of Recession*

The foregoing projections imply a sharp slowdown in the growth of per capita living standards over the next eight years. They will nonetheless prove optimistic if the nation falls into recession. With the economy entering its seventh year of expansion — the longest peacetime expansion in the country's history — many observers worry that a recession is somehow "overdue." But a contraction is not inevitable. The principal cause of recessions in the past two decades has been huge increases in world oil prices, which forced the Federal Reserve to tighten monetary policy enough to throw the economy into a tailspin. Another sudden run-up in the price of oil is unlikely. A crisis in the financial markets is also unlikely, and even if it did occur, it could probably be neutralized by the Federal Reserve. After all, the economy continued to grow briskly after the stock market collapsed in October 1987.

There may be no reason for alarm, but there is no room for complacency either. The dollar is used heavily for trading and investment around the world. The large imbalances in world trade and uncertainties about the ultimate value of the dollar could trigger a sudden run from the dollar. In such an event, the abrupt dollar depreciation could set off a new round of inflation and a marked rise in interest rates. Given the inflationary threat, the Federal Reserve might be reluctant, even unable, to counter the rise in rates with easier money, and thus the economy could fall into recession.

There is no way to predict which of many conceivable events could lead to a "dollar strike." But some people worry about the financial consequences that might occur if the new president brings the country no closer to a resolution of the budget deficit problem. Failure to eliminate the deficit when employment is high could signal to many investors that the United States is unable to manage its financial affairs. Moreover, continued deficits would require the Federal Reserve to keep interest rates high to prevent inflation from accelerating. Higher interest rates would prop up the exchange value of the dollar and thus prevent the trade deficit from reaching long-run equilibrium, aggravating existing uncertainties about the dollar's ultimate value. In such an environment, a sudden run from the dollar is more likely. But if an orderly deficit reduction plan is adopted early in the next administration, the risks of a dollar strike should fall significantly.

If a recession should occur, its severity will depend on the magnitude of the shock that triggers it. A moderate contraction in 1990, comparable in severity to the three that occurred between 1945 and 1960, would cost the nation approximately $500 billion in lost output, or about $2,000 a person. A severe recession, like the 1973–75 and 1981–82 oil shock contractions, would roughly double those losses.

Many believe that the mass of debt, especially corporate debt, that piled up during the 1980s could deepen a recession. The rise of corporate debt, however, may simply cause the negative effects of a future downturn to be distributed differently than in earlier contractions, when construction suffered disproportionately more than the corporate sector. Weakness in the banking industry could contribute to a loss of confidence during a future downturn, but the greater concern is that by further straining many financial institutions, another recession would raise the long-run budgetary and social costs of forcing insolvent banks and thrifts to close or merge with healthier partners *(see p. 36)*.

In the final analysis, the progress made in reducing the federal budget deficit should be the most important determinant of the depth of the next recession. If a contraction occurs some time soon — before serious budget cuts are made — policymakers may be reluctant to stimulate the economy through fiscal measures for fear of aggravating the already perilous deficit situation. A recession triggered by a sudden flight from the dollar could also make the Federal Reserve reluctant to relax monetary policy, which could weaken the dollar still further and add to the inflationary consequences of the dollar's decline. In short, policymakers should act swiftly to implement a meaningful deficit reduction plan if for no other reason than to preserve their ability to stimulate the economy in the future if the need should arise.

## *Recent Trends in Living Standards*

Even if the transition to a balanced economy is managed successfully, the challenge of improving productivity growth — and ultimately living standards — remains. Thus it is helpful to set out what is known about living standards: what has happened to them on average and for different groups; how they will be affected by the economic adjustments that the country will have to undertake sooner or later; and what the federal government can do to enhance the prospects for their improvement.

### *Wage Stagnation*

Any study of living standards must start with an analysis of workers' incomes, since in the long run workers generally spend no more than they earn (and in many cases less, bequeathing the difference to their heirs). Compensation per worker and median family incomes both grew roughly 3 percent a year between 1950 and 1973 but have barely moved since *(see table 2)*.



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*Table 2. Growth of Output, Income, and Spending, 1950–87*

| Period | Output | | Real Income | | Real Domestic Spending Per Capita | |
|---|---|---|---|---|---|---|
| | Per Worker | Per Capita | Compensation per Worker | Median Family Income | Total | Government and Consumer |
| 1950–73 | 1.9% | 2.1% | 2.6% | 3.1% | 2.2% | 2.1% |
| 1973–79 | –0.2 | 1.2 | 0.6 | 0.9 | 1.1 | 1.2 |
| 1979–87 | 0.8 | 1.2 | 0.5 | 0.3 | 1.6 | 1.8 |

Notes: Output is defined as net domestic product. Compensation and median income are adjusted for inflation by the Department of Commerce fixed-weight price index for consumer expenditures. Workers include the self-employed.
Sources: Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

Some have argued that this stagnation reflects a falling share of "good jobs" in the economy. A rising proportion of the American work force is employed in service industries where, it is said, wages are lower than they are in traditional manufacturing jobs. As this shift continues, the argument goes, workers' incomes will continue to stand still.

A closer examination, however, shows that the dominant causes of slow income growth have been macroeconomic in nature — the productivity slowdown and the two oil shocks. Over the long run wage growth is determined principally by advances in the rate of productivity. Between 1973 and 1987, real hourly compensation grew by 0.3 percent a year, a shade less than the 0.4 percent annual growth in output per worker.

If earnings per worker have barely changed in the last 15 years, then how has income per capita advanced rather substantially — from $9,926 (in 1987 dollars) in 1973 to $12,150 in 1987, a 22 percent increase? Two trends explain the apparent inconsistency. The proportion of working-age women who are employed has jumped, from 35 percent in the 1950s to 57 percent today. At the same time, couples are postponing marriage, and when they do marry, they are having fewer children. In other words, a larger proportion of the population is working to support fewer children, allowing income per capita to rise while earnings per worker stay the same. These trends appear to have run their course, however; both the rise in the female labor force and the decline in the birth rate have leveled off.

The slow growth of earnings overall masks sharp differences among groups. Although women are still paid less than men, the earnings gap between the sexes has narrowed over the past 15 years. Average real earnings for full-time male workers of all ages and educational levels actually fell between 1973 and 1986 (the latest year for which data are available). Women's experience was precisely the opposite; average earnings increased across all age and educational categories *(see table 3)*.

The patterns for the two sexes share a common feature however. Less educated workers have fared significantly worse than others. Men aged 25–34 with a high school education and who worked full time have suffered especially large income losses — 16 percent between 1973 and 1986. Individuals in this less educated group also experienced substantial job losses in manufacturing, unlike college-educated men and women, who were slightly more likely to work in goods production in 1986 than they were in 1973.

The overall stagnation of income growth has also led some observers to lament the decline of the "middle class." By one definition — families earning between $20,000 and $50,000 (in 1987 dollars) — the middle class has definitely shrunk. But those who have moved out of it have moved up. The percentage of families earning more than $50,000 has increased while the share below $20,000 has remained constant *(see figure 1)*. In short the story behind the "vanishing" middle class is that more families have gained ground than lost it.

Just the reverse has happened among poorer American families. While the percentage of families earning less than $20,000 has not gone up, the proportion in it with incomes below $10,000 has. In 1973, 10 percent of America's children lived in the poorest families; by 1986 that number had shot up to 16 percent. Fully one-third of the nation's children now live in families with incomes below $20,000. At the same time the proportion of children in families with incomes above $50,000 has risen, reflecting more two-earner families. The rising inequality among children poses an increasingly serious challenge to the nation.

## *Regional Differences*

Factory closings in the so-called Rust Belt states of the North and East are often blamed for at least some of the



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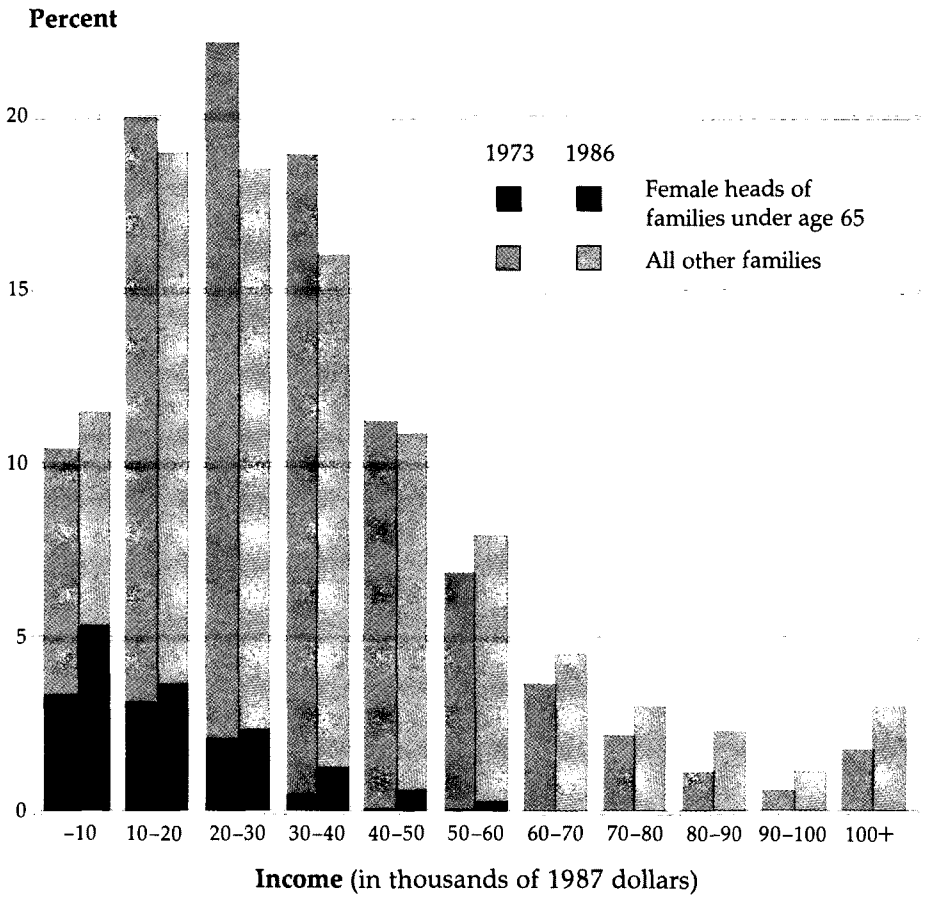


***Figure 1. Family Income, 1973, 1986***

Source: Bureau of the Census, *Current Population Reports.*

***Table 3. Education and Income, by Age and Sex, 1973, 1986***

| Age, Education Level Completed | Mean Annual Earnings 1973 | 1986 | Percent Change |
|---|---|---|---|
| *Men, 25–34* | | | |
| High school | $24,644 | $19,387 | –21% |
| College | 28,569 | 28,792 | 1 |
| *Men, 35–44* | | | |
| High school | 28,461 | 24,992 | –12 |
| College | 42,266 | 37,728 | –11 |
| *Men, 45–55* | | | |
| High school | 29,353 | 24,922 | – 8 |
| College | 44,332 | 42,696 | – 4 |
| *Women, 25–34* | | | |
| High school | 9,599 | 11,182 | 16 |
| College | 14,561 | 18,924 | 30 |
| *Women, 35–44* | | | |
| High school | 10,697 | 12,570 | 18 |
| College | 14,564 | 20,050 | 38 |
| *Women, 45–55* | | | |
| High school | 11,967 | 13,199 | 10 |
| College | 18,439 | 19,503 | 6 |

Note: Data includes men and women who worked at least one hour during the year. The college category excludes people with post-graduate education. Earnings are in 1987 dollars.
Source: Bureau of the Census, *Current Population Survey,* microdata files.



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*"If productivity had continued to grow throughout the postwar period at the 3.25 percent rate recorded between 1948 and 1965, output in 1987 would have been 50 percent higher than it was. The median income of the American family — roughly $30,000 in 1987 — would have been about $45,000."*

perceived decline of the middle class in those states. A review of wage and income growth across the regions of the United States tells a different story.

The relative decline of the Rust Belt is not a recent phenomenon. In fact, population, incomes, and companies have been moving from the Rust Belt to the Sun Belt states in the South and West since the 1930s, and aggregate real incomes have been growing faster in the Sun Belt than in the Rust Belt for at least five decades *(see table 4)*. Earnings derived from goods production, now concentrating in the South, follow a similar pattern. But factory closings are not responsible for these trends; plants have been shutting down with equal frequency in both regions. Instead, the Rust Belt states have been losing ground because they have been unable to attract new plants.

Why is that the case? The popular view that manufacturers have been moving to the Sun Belt primarily to take advantage of lower wages must be rejected. If that view were true, then the manufacturing wage differential between the two regions should have narrowed over time. But that has not happened *(see table 5)*.

Nor can unionization be as potent a motivation for plant location as it was in earlier generations. With unions representing only 24 percent of all manufacturing workers in 1986 (down from 52 percent in 1958), regional differences in unionization could not significantly affect the average manufacturer's decision about where to locate plants. Japanese auto companies and American steel minimills may be so motivated, but they account for a small share of total manufacturing employment in the United States.

The Sun Belt may well be more attractive than the Rust Belt because many of the states in the region appear to be more hospitable to new business. Besides the business climate, better weather itself may account for a sizable portion of population and job shifts to the South and West. As industry no longer needs to be near Appalachian or midwestern coal, or near Minnesota iron ore, steel and steel fabricating plants can move away from the harsh winters of the Great Lakes. Other industries follow. Unionization and relatively high wages in the North may be partly responsible for the shift of industry southward and westward, but it is more likely that many Americans simply wish to live in a more genial climate.

Furthermore, contrary to some popularly held views, regions of the country can raise the incomes of their citizens by succeeding outside the manufacturing sector. The gap in per capita incomes between the Rust Belt and the Sun Belt narrowed between 1930 and 1980, even though manufacturing wage differentials remained relatively constant. The explanation: Sun Belt states have been especially successful in raising incomes through jobs in services rather than in manufacturing. The income differential between North and South has widened somewhat in the 1980s but only because of growth in nonmanufacturing industries in New England and the Middle Atlantic states.

Many regions of the country have not participated in the economic expansion of the 1980s, a fact reflected in the employment patterns across the states. But plant closings are not the cause. Instead, these regions have been hurt by an unusual degree of instability in energy and agricultural markets and by extraordinary fluctuations in interest rates. If future macroeconomic policies create a more stable business environment and if the nation can avoid the shocks of the 1980s, the disparities in unemployment rates across states should narrow. Nonetheless, people will probably keep moving to the Sun Belt and the income gap between North and South should grow smaller.

## *The Productivity Puzzle*

If the United States is to improve living standards over the long run, it must increase productivity. A very simple exercise illustrates the effect productivity growth has on living standards. If productivity had continued to grow throughout the postwar period at the 3.25 percent rate recorded between 1948 and 1965, output in 1987 would have been 50 percent higher than it was. The median income of the American family — roughly $30,000 in 1987 — would have been about $45,000.

Fully reversing the productivity slowdown of the last two decades would be a remarkable achievement and should not be counted upon. But, as the projections in table



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1 indicate, strong productivity growth is essential if average living standards are to advance significantly while the country adjusts its spending patterns and if the nation is to avoid a decline in the future living standards of its least educated workers.

The problem is that no one knows for sure what has caused productivity growth to decline. The slowdown is not a uniquely American phenomenon; other industrialized countries have also experienced a falloff in their growth rates. Nor is the slowdown attributable to measurement errors that underestimate the output of the service industries. Productivity in the service sector, the one area of the economy in which productivity is most difficult to measure, rose at a healthy annual rate of 2.4 percent from 1948 through 1965 but advanced only 0.1 percent a year from 1979 to 1987. Clearly, if service productivity grew at a healthy pace in the past, its failure to grow rapidly in recent years cannot simply be dismissed as a measurement phenomenon.

Modest contributions to the decline can be identified. The population shift away from less-productive small farms and toward more productive self-employment endeavors ended in the mid-1970s. The costs of meeting health and safety regulations rose while the growth of capital per worker fell. But altogether, these factors account for only about two-fifths of the falloff in productivity growth.

### *Productivity and Management*

What else, then, could account for the slowdown? Some observers have blamed American business managers, charging that they have concentrated on short-term profits at the expense of long-term research and investment. No hard evidence supports this allegation. Nevertheless, American companies in many industries seem to have lost ground in world markets to an extent that cannot be attributed solely to the overvalued dollar of the 1980s. At least part of this loss can be blamed on the reluctance of many of those companies to compete aggressively for market share by cutting prices, a tactic that has worked well for Japanese companies. Indeed, one reason American manufacturing productivity has rebounded in the 1980s may be that the overvalued dollar and the 1981–82 recession forced U.S. manufacturers to improve their performance simply to survive against the increasingly

### *Table 4. Regional Differences in Annual Growth in Real Personal Income, 1940–87*

| Period | U.S. | Sun Belt | Rust Belt | Difference |
|---|---|---|---|---|
| 1940–50 | 4.7% | 6.3% | 3.9% | 2.4% |
| 1950–60 | 3.3 | 4.1 | 2.8 | 1.3 |
| 1960–70 | 4.7 | 5.4 | 4.1 | 1.3 |
| 1970–77 | 3.2 | 4.3 | 2.2 | 2.1 |
| 1977–87 | 2.5 | 3.2 | 1.8 | 1.4 |

Note: Real personal income equals personal income divided by the personal consumption expenditures deflator.
Source: Department of Commerce, Bureau of Economic Analysis.

### *Table 5. Regional Differences in Average Manufacturing Wages, 1967, 1985*

| | 1967 | | 1985 | |
|---|---|---|---|---|
| | Dollars per Hour | Share of East North Central Wage | Dollars per Hour | Share of East North Central Wage |
| *Rust Belt* | | | | |
| New England | $2.75 | 0.83% | $ 9.35 | 0.81% |
| Middle Atlantic | 2.94 | 0.89 | 9.86 | 0.85 |
| East North Central | 3.30 | 1.00 | 11.58 | 1.00 |
| West North Central | 2.95 | 0.89 | 10.20 | 0.88 |
| *Sun Belt* | | | | |
| South Atlantic | 2.36 | 0.72 | 8.33 | 0.72 |
| East South Central | 2.40 | 0.73 | 8.59 | 0.74 |
| West South Central | 2.65 | 0.80 | 9.69 | 0.84 |
| Mountain | 2.98 | 0.90 | 9.88 | 0.85 |
| Pacific | 3.28 | 0.99 | 10.41 | 0.90 |

Source: Authors' calculations based on data from the Bureau of the Census, *1985 Annual Survey of Manufacturers, Geographic Area Statistics.*



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stiff challenges posed by their overseas competitors.

The wave of corporate mergers in the 1980s has also stimulated a vigorous debate about the effectiveness of American managers. Critics of the takeover movement contend that many mergers are inefficient, waste social resources, and divert managers from concentrating on improving the performance of their businesses. Supporters respond that takeover threats discipline managers and offer incentives for them to increase productivity.

In fact, this debate may be tangential to the productivity issue. The fact that merger activity is highly episodic — the current wave is the fourth of the century — suggests that mergers and takeovers represent a sometimes brutal but often necessary way to break up longstanding but inefficient practices and relationships and to create more efficient ones. Although many mergers will fail to improve the performance of the companies involved, allowing them to proceed nonetheless facilitates experimentation and innovation. Proposals to limit takeovers could inhibit productivity growth in the long run by locking companies into old and less productive patterns and relationships.

### *Spurs to Improvement*

Nonetheless, there is a need for policies that ease the pain of restructuring, whether or not it is motivated by takeover. Federal policies that help workers relocate or retrain are not only humane but also contribute to long-run productivity by encouraging labor to be more mobile, flexible, and responsive to rapidly changing markets. Advance notice of plant closures facilitates this process by giving workers some time to plan for and make the necessary adjustments to new realities.

A number of changes in government policy could enhance productivity. These include increasing government funding for technology research; shifting the emphasis in "R&D" toward development; and retaining the tax credit for private research and development expenditures, but revising the credit formula to encourage companies that have been unable to increase their R&D commitments to sustain a strong R&D effort nevertheless. Intellectual property laws might be revised to provide greater incentives for innovation. Moreover, just as fluctuations in interest rates, inflation, and exchange rates lead to greater instability across different regions of the United States, they also make it difficult for American managers to manage effectively. A more stable economy should therefore enhance business productivity.

At bottom, however, the lion's share of the responsibility for improving productivity in the workplace rests with American business itself. American managers must learn from their foreign competitors, adapting and improving upon technology developed in other countries. American companies could reap greater benefits by paying closer attention to incremental improvements in technology as their Japanese counterparts do, rather than betting scarce R&D funds heavily on finding dramatic breakthroughs.

That does not mean, though, that the government should allocate research tasks among companies. Americans would do well to remember that industrial policy in other countries, particularly in Europe, has failed when government policymakers badly misjudged market forces. The safest and most appropriate role for the U.S. government is to provide broad support for technology development, leaving it to the marketplace to sort out the winners and losers.

*"... in the long run, the skill level of the work force affects productivity. Thus, if the nation wants to raise its productivity growth, it should improve the educational system in ways that maximize the potential of the work force."*

## *The Role of Education*

The nation's well-being is dependent on the skills of its people, which in turn are heavily influenced by education and training. Unfortunately the quality of America's schools, as measured by students' performance on standardized tests, declined from the mid-1960s through the mid-1970s. Although this deterioration does not appear to have played a significant role in the slowdown of productivity growth thus far, its ill effects could show up in the future. In any event, there is no doubt that in the long run, the skill level of the work force affects productivity. Thus, if the nation wants to raise its productivity growth, it should improve the educational system in ways that maximize the potential of the work force.

That is not happening today. However well intentioned, too much of the effort to reform the schools has been



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directed at improving the ability of students to read and to perform routine arithmetic. In a dynamic economy in which new technologies are constantly bringing new products to market and changing the way products are made and services delivered, this approach to educating the future labor force is hardly ideal.

Instead, the United States should be teaching children the crucial skills necessary for success on the job — the ability to use reading and mathematical skills to solve problems, including problems in the workplace. Moreover, the United States must have as its national education objective the teaching of problem-solving skills to all students, not just the select few who choose to go on to professional careers.

The nation now falls far short of meeting that objective. Sizable numbers of American students are able to read and perform many basic arithmetic exercises but show little, if any, ability to solve multistep problems of the sort that the workplace requires. Children from poor families or from minority backgrounds fare worst of all, and they are the ones who will constitute a growing proportion of the future labor force.

Although the United States has a long tradition of limiting the role of the federal government in education, federal policymakers could take a number of steps to promote these national goals for education. The Head Start program has shown significant promise and should be extended to as many eligible children from poor families as possible; only 20 percent of the 2.4 million eligible poor children are currently served. The Summer Training and Education Program, designed to use the summer months to enhance the reading and mathematics skills of disadvantaged children, has a similar positive report card and should be expanded. Federal funding of compensatory education programs — aimed at school districts serving poor children — is desirable, especially if the funds can be targeted on those who particularly need them.

Evidence that American students fall behind their Japanese counterparts in mathematics as early as the fifth grade indicates that summer training institutes for math teachers should be open not only to high school teachers but to those from junior high and primary schools as well. Incentives for inducing college math majors to teach should be upgraded; perhaps federal tuition grants should be given in exchange for commitments to teach in urban schools.

The federal government should also consider ways that it might increase the emphasis schools place on problem-solving skills, particularly on standardized tests. If the United States wants its future labor force to be trained in problem solving, then tests must be designed that measure such skills, thus offering incentives to teachers to teach them. Whether at the federal or local level, policies that reward progress in raising children's reading and math skills and do not reward children's comprehension and problem-solving skills will lead to the neglect of the latter. One approach the federal government might consider is funding the development of exemplary grade-specific exercises that focus on problem solving.

*"Moreover, the United States must have as its national education objective the teaching of problem-solving skills to all students, not just the select few who choose to go on to professional careers."*

At the same time, the wisdom of several widely discussed education reform proposals must be questioned. Merit pay programs for teachers, for example, have not been successful so far in improving student performance. In fact, some evidence shows that merit pay may detract from the teamwork by teachers that is often necessary for success. Longer school periods — either more days or more hours each day — have not proved cost beneficial and are unlikely to do so unless new material is added to school curricula. And simply introducing computers into the classroom will not improve workplace skills if, as is often the case, they are used simply to provide more drill and practice of basic reading and arithmetic skills.

Even the adoption of appropriate reforms will not materially improve the job prospects of many children from poor families, where the resources and environment conducive to educational progress are often lacking. In the end, poor families need more income if they are to provide an environment in which their children can learn.

*The authors wish to thank their co-authors of* American Living Standards: ***Frank Levy*** *for his work on incomes;* ***Robert W. Crandall*** *for his work on regional economics;* ***Martin Neil Baily*** *and* ***Margaret Mendenhall Blair*** *for their work on the causes of the productivity slowdown; and* ***Richard Murnane*** *for his work on education.*



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*Joshua M. Wiener*

# *Taking Care of the Uninsured*

The United States faces two serious gaps in ensuring access to health care services and protection from catastrophic costs to all its citizens. First, between 25 million and 37 million children and working-age Americans lack any insurance coverage to help pay for the acute care costs of physicians and hospitals — and their numbers are increasing. Second, virtually all Americans lack insurance to help pay for the almost always catastrophic costs of long-term nursing home and home care.

Virtually all elderly Americans are covered for acute care by Medicare, the federal medical insurance program. Most working-age Americans and their children are covered for acute care by health insurance provided through their jobs. Not all employers, however, offer insurance: over half of uninsured adults are employed either full-time or part-time, most at low wages. Some low-income uninsured are covered by Medicaid, the federal-state health care program for the poor, but most are not. Medicaid's financial eligibility ceilings are extremely low — less than 50 percent of the poverty line in most states — so that most low-income people do not qualify for benefits. In addition, Medicaid covers only certain categories of the poor — principally the aged, blind, disabled, and families with dependent children. People who do not fit the categories are simply out of luck, regardless of how serious their health needs are.

The consequences of lack of insurance or Medicaid coverage are severe. In 1986 an estimated 14 million people had serious difficulty paying for needed medical care, and 1 million Americans who could not pay were turned away from a hospital or physician. Hospitals, under growing pressure to hold down costs, are increasingly reluctant to provide the roughly $7 billion a year in uncompensated care, which must be passed on as a price increase to private insurers and Blue Cross.

## *Possible Options*

Proposals to address health coverage for the under-65 population abound, and almost all would be improvements over the current situation. One option is to provide federal grants to the states to help fund health care for the uninsured. In 1983, 29 states spent a total of $1.8 billion for their own programs for the uninsured. A grant program would be simple for the federal government to operate, but funding would probably lag behind need, and an array of separate state programs does not address the basic structural problem of providing individuals with a reliable source of health care.

Another option is to require that states expand their Medicaid programs to cover a greater proportion of the poor, who should by all rights have first claim on any additional federal spending. This approach builds on existing administrative and financing structures. Ideally, all poor would be eligible, not just those fitting the existing Medicaid eligibility categories. One problem with this approach is that the states that would be required to expand eligibility — and thus increase costs — are also those with relatively low tax bases. Moreover, some uninsured workers will not qualify financially, and others who do will not want to apply for a means-tested welfare program.

Yet another problem with these two approaches is that they would require substantial new federal spending in an era of large budget deficits. An alternative is some form of mandatory employer-subsidized health insurance. Under this approach, employers and employees, not the government, would shoulder the additional costs. For example, a bill introduced in the Senate would require employers to provide a basic package of health benefits to all employees working at least 17.5 hours a week and to their families. Ironically, although currently opposed by many business groups, the plan is similar to one proposed in 1974 by Senator Paul Fannin, a staunch conservative, and supported by the U.S. Chamber of Commerce as an alternative to national health insurance.

This approach would move a majority of uninsured Americans into the mainstream of private health insur-

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ance. There would be no welfare stigma, and the incentive to work would be increased. Opponents, however, fear that the health insurance mandate would so raise the labor costs of the affected companies (especially if it comes on top of a minimum wage increase) that the businesses would become unprofitable or be forced to lay off workers. However, results from several macroeconomic models suggest that the national job loss would be small, perhaps 150,000 jobs over three years. If health insurance comes at the expense of reduced wages, then it represents a per capita "tax" on low-income employees, which is especially regressive. Thus, tax breaks of some sort are critical to ease the financial burden on affected businesses and workers.

In the end, every option proposed requires federal help — either additional federal spending or tax expenditures. To avoid increasing the already too large federal deficit, some form of increased taxes will be needed. One way to raise revenue is to change the tax treatment of health insurance. Currently, contributions by employers for medical insurance premiums are not considered to be income for the employee. This exclusion will cost the Treasury $28 billion in fiscal year 1989 alone; costs will balloon to $46 billion by 1993. Setting a dollar limit on the premiums that could be excluded could both raise revenue and help to dampen some of the inflationary pressures in health care. There is also some justice in having people fortunate enough to have comprehensive health insurance help pay for the health care of those with no coverage.

## *Long-Term Care*

For long-term care, the problem is not the lack of a safety net, but rather a system that forces many otherwise self-sufficient people to turn to welfare as the only way to pay for their long-term care expenses. The United States does not have, in either the private or the public sector, satisfactory ways of helping people anticipate and pay for home care and nursing home care. The cost of a year in a nursing home averages about $22,000, far beyond the reach of most senior citizens. Medicare and private insurance currently offer virtually no help. Nursing home patients must use their life savings to pay for their care. Once impoverished, they turn to welfare in the form of Medicaid.

The financing of long-term care can be improved in a variety of ways. One approach is to rely on the private sector. For example, there is substantial room for growth in private long-term care insurance. A potential multibillion-dollar market has barely been tapped. But the private sector cannot be relied on to do the whole job. Private sector options are both too expensive to be affordable by most elderly and too limited in the financial protection that they offer. By 2018, private long-term care insurance for those aged 65 and older is likely to be affordable by no more than 25–45 percent of the elderly, to account for 7–12 percent of total nursing home expenditures, and to reduce Medicaid expenditures and the number of nursing home patients by 1–5 percent.

*"This approach would move a majority of uninsured Americans into the mainstream of private health insurance. There would be no welfare stigma. . . ."*

Even maximum development of private-sector initiatives will leave the public sector a large responsibility for financing long-term care. The question then is: Should the nation stick with a means-tested welfare program for financing long-term care, or should it enact a new program of social insurance?

The principal argument for staying with Medicaid is that it meets the most urgent needs of the disabled elderly population at minimal cost to taxpayers. The problem is that public charity always carries some stigma. Normally a welfare program exists to help only a small minority of the population. But most people who enter nursing homes end up on Medicaid. The experience can be shattering to men and women who are also adjusting to being disabled and institutionalized.

A better approach would be to adopt a limited program of public insurance, retaining a sizable role for the private sector. Under such a system, everyone would contribute to and earn the right to benefits when they need them without having to prove that they are financially needy.

Public costs and the taxes necessary to pay for such an insurance program would be substantial but manageable. Since society will incur most of these costs with or without a public insurance program, the key issue is whether these costs will be borne largely by the relatively few who need extensive care, or by society as a whole. Depending on program design, the public costs of a social insurance program would range between $38 billion and $47 billion in 1988, compared with $22 billion under current policies.

Revenue for such a program could be raised through a payroll tax of 2.4–3.1 percent distributed half on employers and half on employees (with no cap on taxable salaries). Public long-term care programs are not now financed on a payroll tax basis; if they were, the cost would amount to 1.6 percent of total payroll. The proposed increase for long-term care, while sizable, is clearly not impossibly large. The payroll tax should be minimized by increases in estate or inheritance taxes, income tax surcharges, excise taxes, and premiums paid by the elderly, as well as through the retention of some state financial responsibility for long-term care.

America's pluralistic system of financing health care serves most people pretty well. Helping those who have no access to basic health care services and no protection against the costs of long-term care is critical to making America a more just society.



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*Anthony Downs*

# *The Housing Challenge*

Although most U.S. citizens are among the best-housed people on earth, many, especially those in poor and youthful households, are struggling unsuccessfully to rent or buy homes. Their problems have intensified during the 1980s and are likely to make housing a far more prominent public policy issue in the 1990s than it has been.

The shortage of rental housing units affordable by low-income households is acute and worsening. The rent "affordable" — that is, costing no more than 30 percent of each household's pre-tax income — by households with incomes below $10,000 is $250 a month or less. In 1983, there were more than 12 million such households. But only 8.75 million units were for rent at that price, and about half those were occupied by households with incomes above $10,000.

This shortage helps explain why as many as 750,000 people are homeless today, mainly in large cities. Half to two-thirds are suffering from mental illness, drug abuse, or alcoholism, but many are just so poor they cannot afford homes. With up to several million low-income housing units likely to lose their federal subsidies over the next 20 years, the problem will only get worse.

A second housing issue concerns homeownership, a foundation of "the American dream." The housing industry claims that buying a home is also becoming unaffordable to more and more households, especially young ones. That is especially true in the 10 metropolitan areas with the highest priced housing, where median prices of existing single-family homes exceed $130,000. These areas are home to about 20 percent of the U.S. population.

In fact, however, nationwide homeownership rates have actually been edging up for more than a year. In addition, much of the decline in homeownership rates in the early 1980s resulted from two unusual trends. One was higher default rates on home mortgages. The other was abnormally high homeownership rates among young people in the 1970s because of negative real interest rates and rapid inflation.

Nevertheless, two major determinants of homeownership costs — land costs and interest rates — have both risen much faster than household incomes over the past 20 years. It is more difficult for many young households to buy homes today than it was for their parents — though the homes most want to buy are larger and more luxurious than those their parents occupied.

In a few metropolitan areas, average housing costs have become so high that even acute labor shortages are failing to attract new residents. Potential workers living elsewhere simply cannot afford housing there. That is likely to slow economic growth and perpetuate labor shortages in such areas. Both effects distort the nation's economic efficiency. This situation exists in the Boston, Hartford, New York, Long Island, Washington, and San Francisco metropolitan areas. The Orange County, California, and Los Angeles areas also have high prices but are still attracting newcomers.

## *Underlying Causes*

These housing-related problems have three principal causes. One is the poverty of millions of Americans. Their incomes are so low they could not afford to occupy decent quality housing units without paying excessive fractions of their incomes for housing, even if there was no shortage of low-rent units. What such households need is either higher incomes or housing furnished at rents subsidized to levels below the actual costs of occupancy. Because only the federal government can provide such assistance on the scale needed, federal housing subsidies, income supplements, or job programs must be enacted to cope with this cause of housing problems.

The second major cause is an unnecessary inflation of housing occupancy costs due to local government regulatory policies. Such policies, which homeowning voters in the communities concerned strongly support, drive up land costs and require housing quality standards far beyond the minimums needed for health and

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safety. These regulations include restricting land zoned for multifamily housing; requiring large minimum lot sizes and dwelling unit sizes; forcing developers to pay the full costs of furnishing schools, streets, parks, and other amenities; and requiring builders to endure lengthy delays in getting permission to construct housing. All these policies are designed to protect homeowners from forces that they believe might reduce existing home values, including the entry of households with low incomes.

Federal attempts to reduce the stringency of local zoning have failed because they have not given the most restrictive local governments any incentive to change their behavior. The federal government cannot effectively threaten to cut funding to such governments, because they now receive very little federal aid. Furthermore, Congress is dominated by suburban representatives. Probably the only workable federal strategy is to pressure state governments to impose limits on local zoning powers, using the threat of reducing federal financial aid to states. If local zoning powers are not limited somehow, additional federal spending on housing subsidies will be largely offset by higher land prices resulting from even more restrictive local regulations.

The third cause of the housing problem, high real mortgage interest rates in the 1980s, is not likely to be solved by government action. The high rates result from national monetary policies adopted for reasons unrelated to housing, and monetary authorities are not likely to set interest rates with housing-related goals in mind.

## *Federal Solutions*

The Reagan administration chose not to address these housing problems. Innovative tactics developed by state and local governments and private interests to fill the void were only marginally effective, because they were implemented on a relatively small scale. Only the federal government can solve the nation's housing problems because only the federal government can raise money on a sufficient scale to fund housing assistance for low-income households. If state and local governments were to tax their nonpoor residents enough to redistribute adequate resources to their poor ones, many of the former would move to nearby jurisdictions that have no such policies.

What is needed is a federal housing strategy for the 1990s with five substantive goals.

*The existing inventory of housing affordable to low- and moderate-income households should be preserved.* This inventory includes public housing, privately owned units subsidized under federal programs about to expire, and very low-rent, privately owned, unsubsidized units. Keeping these units affordable to low- and moderate-income households will require renewing many existing federal subsidy programs, upgrading viable public housing projects, converting unsuccessful high-rise projects from their current use, and furnishing housing vouchers to residents of units that will lose their subsidies over the next two decades.

*"Housing vouchers . . . should be provided to low-income families who otherwise cannot afford decent quality units."*

*Subsidies should be provided for construction of additional rental housing in markets with acute shortages, especially of low-rent units.* One strategy is to build many new rental units with "shallow" subsidies for moderate-income households and rely mainly upon "trickling down" — the availability of units left behind by families moving to the new units — to aid low-income households. Another is to build far fewer, but "deeply" subsidized, units to be occupied directly by low-income households. Which strategy is superior depends mainly upon conditions within each metropolitan area. This goal includes creating adequate short-run shelters for the homeless.

*Housing vouchers or similar rent supplements should be provided to low-income families who otherwise cannot afford decent quality units.* Vouchers increase the incomes of poor households, thereby attacking the central cause of housing affordability problems: poverty. This tactic is most effective in metropolitan areas without shortages of existing rental housing units.

*The ability of local governments to raise housing occupancy costs should be limited by requiring each state to regulate its zoning laws before it is eligible for federal housing aids.*

*The ability of young households to amass down payments for home purchases should be increased through various tax-sheltered savings devices.* An example is permitting IRA funds to be used for housing down payments. This goal is more important as a means of winning middle-class support for federal housing aid than as a means of meeting severe housing needs.

*Although the Department of Housing and Urban Development should resume its role as an effective policy instrument, detailed planning and implementation of housing policies should be done at the state, metropolitan area, and local levels.* Because housing markets are local in nature, coping with their deficiencies requires tailoring actions to local conditions. That is best done by building upon the recent innovative efforts of state and local governments in partnership with both profit and nonprofit organizations. These locally oriented actors should draw up specific plans to meet local deficiencies, choosing among many available tactics. Though states should provide some matching funds, those plans would then be funded mainly with federal money flowing through states.

In short, housing should again become a national priority. The change will not be easy. Funding expanded housing aids during a period of continuing budget deficits will require a radical shift of values by both the next administration and the next Congress.



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*R. Dan Brumbaugh, Jr. and Robert E. Litan*

# *Facing Up to the Crisis in American Banking*

On his inauguration day in March 1933, President Franklin D. Roosevelt halted the most serious bank crisis in this nation's history by declaring a "bank holiday." Shortly thereafter Congress implemented a program of deposit insurance, one of the most important components of the New Deal.

Upon taking office in January 1989, our new president will face the gravest banking crisis since 1933. At least 500 of the nation's 3,000 or so thrift institutions are insolvent. The eventual cost to the government of liquidating them or forcing them to merge with healthier partners will likely exceed $60 billion. By comparison, the insurer of thrift deposits, the Federal Savings and Loan Insurance Corporation (FSLIC), will have new cash of only about $15 billion coming in through the end of 1990.

Many banks are in trouble, too. The numbers of failed banks have risen from just 10 in 1980 to 184 in 1987. In 1988 the total is likely to top 200 and includes two of the largest banks ever to fail, First Republic of Texas and MCorp. For the first time in four decades, total reserves held by the insurer of bank deposits, the Federal Deposit Insurance Corporation (FDIC), will fall, from $18.3 billion at the end of 1987 to $15 billion (or maybe less) at the end of 1988.

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The crisis among the nation's depository institutions needs immediate attention. With no capital left, but with federal guarantees of their deposits, insolvent depositories are largely free to take risks. It is little wonder that the cost of cleaning up the mess in the thrift industry alone is growing by an estimated $1 billion a month.

Perhaps even more damaging, insolvent banks and thrifts bleed their healthy competitors. To remain liquid, depository institutions with little or no capital must offer high interest rates on their deposits to attract funds. But their efforts bid up the cost of funds for their soundly capitalized competitors and thus impair the health of both the bank and thrift industries.

To minimize the ultimate cost of restoring the American depository industry to health, the new president must act quickly and decisively. At the same time steps must be taken to ensure that another bank and thrift crisis doesn't happen.

The short-run task is simple, if painful. All insolvent commercial banks and savings and loans still in business must be put up for auction to potential acquirers from anywhere in the country. The federal insurance agencies can cover the gap between liabilities and assets (negative net worth), but in contrast to current practice, acquirers must ensure that the surviving institutions meet minimum net-worth standards in no more than three years. If the insurance assistance to a merger is greater than the cost of simply paying off the insured depositors, then the institutions should be liquidated. We believe that if the government made a firm commitment, all insolvent depository institutions could be put out of business or merged within two years.

There is no escaping the fact that the American taxpayer will have to bear much of the cost of cleaning up the thrift and bank industries. Because the primary purpose of deposit insurance is to protect against runs that could destabilize the economy, taxpayer payments are appropriate. But, as a political reality, other potential funding sources will have to be exhausted first.

## *Array of Options*

Healthy thrift institutions have already been tapped heavily; they are paying deposit insurance rates of almost 21 basis points (a little more than two-tenths of a percent of deposits), or two and a half times the 8.3 basis points that commercial banks pay. The additional premium totaled 40 percent of the thrift industry's net operating income in 1987 and will surely contribute to more insolvencies. Raising those premiums even further could cripple the industry.

A more sensible option is to equalize the deposit insurance premium rates paid by healthy banks and thrifts at a point somewhere in between the current disparate levels. Since banks have roughly double the insured deposits of thrifts, an equal premium policy would

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raise total bank and thrift premiums combined. Counting expected deposit growth, the additional premium income could be used to service another debt issue of up to $10 billion to pay for the closure or forced merger of insolvent depositories.

Of course, banks can be expected to complain that any proposal to raise their insurance premiums would unfairly penalize them. After all, they would argue, banks should not be held responsible for the misjudgments and misdeeds of now insolvent thrifts. But healthy thrifts, which are already being penalized by having to pay higher deposit insurance rates, can make the same claim. Moreover, both healthy banks and thrifts would benefit from a resolution of the thrift problem by not having to compete with high interest rates offered by insolvent but operating institutions.

A merger of the FDIC and the FSLIC has been proposed as another potential source of funds. But there is less to this option than meets the eye. We estimate the FDIC will have to spend at least $7 billion, and possibly much more, to cover the costs of merging or liquidating banks that are now insolvent. If the economy should dip into recession, bank problems would be worse. Under these circumstances, it would not be wise to count on more than $5 billion from the current reserves of the FDIC.

Others have suggested raising funds by taxing thrift savings accounts or mortgage loans. Neither of these options is desirable. Taxing savings accounts would simply induce thrift depositors to transfer their funds to banks or money market funds. As for a tax on mortgages, why should homebuyers bear a disproportionate burden for funding the thrift cleanup?

When all is said and done, nontaxpayer sources can be expected to provide about $30 billion at most to help resolve the thrift crisis. This figure could be larger if one counts the expected deposit insurance premiums that the thrift industry will pay over the next decade. But much, if not all, of this additional premium income will probably be needed to pay for future thrift failures.

In short, if the cleanup cost is $60 billion, taxpayers will need to foot at least $30 billion of the bill. That is a difficult political pill to swallow, especially if the cleanup cost is much higher than $60 billion. But ignoring it will only make the ultimate cost to the taxpayer even larger.

## *Preventing Recurrences*

Taxpayers deserve something for their money. The nation's financial laws and deposit insurance system must be reformed so that widespread insolvencies do not recur.

First, new accounting standards must be phased in to require all depositories to provide more realistic, market-based representations of their true capital positions.

Second, federal regulators should have the authority to auction off or liquidate a depository even before its capital falls to zero, so that the government need not systematically take a loss, as it now does. To prevent bank lawyers from stalling the auction or liquidation process, federal authorities should be enabled to take temporary custody of under-capitalized institutions during any legal challenge to the insurance agency's decision to "bear down" on the institution.

Third, poorly capitalized institutions should not be permitted to pay dividends until their capital is brought up to the minimum standards set for banks.

Fourth, consolidation of the bank and thrift industries (and their insurers, for administrative purposes) is desirable but not necessary. If they are consolidated, the separate accounting and closure rules, capital standards, insurance premiums, activity authority, and tax treatment for the two industries should be harmonized over a five-year period.

Finally, serious attention must be given to reforming the nation's antiquated bank ownership laws. In an effort to minimize the costs of resolving the thrift crisis, federal regulators are allowing many companies from outside the banking industry into the depository business. Although that has the salutary benefit of bringing additional capital to the industry, it is hardly the preferred way of resolving the controversial question of which types of organizations should be permitted to own an insured depository.

For years, Congress has had no success in settling this debate about ownership, largely because of continuing disagreement among the banking, securities, insurance, and real estate industries. Financial structure issues, however, may soon be elevated from their current domestic context to an international one. As part of its planned integration in 1992, the European Community (EC) has proposed a controversial rule that would bar American and Japanese financial institutions from expanding their operations in Europe if European "universal" banks are not given the same rights to operate here (and in Japan) as they have in Europe.

In essence, the Europeans are threatening to close their markets if the United States does not copy their financial laws, which give banks much greater freedom to engage in securities and other financial businesses than U.S. banks are allowed. Although the EC's proposal may be no more than a threat, it must nevertheless be taken seriously.

The next administration can prevent a major showdown with the EC by beginning, early in its term, a negotiating effort with the European Community, Japan, and Canada (which reformed its financial laws in 1987) to agree on some basic ground rules for competition by financial service businesses in each country. In the process, the United States should insist on a legal structure that protects the safety and soundness of the banking system in all countries, as well as the integrity of its own deposit insurance system. As in prior trade negotiations, leading congressional figures should be involved in the talks, with the final product subject to "fast-track" congressional consideration.

In short, the "internationalization" of the financial structure debate may be the key to resolving the ownership problem here in the United States. It is an opportunity that the next administration should not miss.



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*Robert A. Katzmann*

# *The President and the Federal Courts*

Presidential candidates talk about the kinds of nominations they hope to make to the federal judiciary. But a chief executive who thinks only about appointments to the bench, and nothing about the institutional well-being of the courts, may find that those ideal candidates are less willing to accept judicial appointments or to remain on the bench for very long. And without a strong federal judiciary, government and society will suffer.

Ours is a litigious country, and we expect courts to adjudicate ever more complex disputes. The president and Congress increase the judicial caseload deliberately; sometimes they do so inadvertently, when, for example, they do not anticipate problems that the courts are then asked to settle. The judiciary is saddled with these responsibilities, but without the requisite additional resources. Only about one-tenth of a percent of the federal budget is devoted to the federal judiciary each year. Yet it is treated as an elastic institution capable of absorbing any demands.

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The cumulative effects should give us pause. Workloads, especially at the district court level, are backbreaking. Since 1969 the purchasing power of the federal judge's paycheck has fallen about 30 percent, making it hard to attract lawyers to the bench, especially those with college-age children. In the end, as Judge Frank M. Coffin has put it, jurists "are in danger of losing the respect, serenity, and independence that the Constitution sought to vouchsafe."

The new president can help redress this state of affairs. Here are some steps he might take.

First, the chief executive should direct the attorney general to organize the Department of Justice to make the administration of justice — the functioning of the various institutions that affect and make up our system of justice — a matter of high and continuing priority. The department should be structured, through either a separate departmental office or a unit within each operating division, to consider the impact of its actions on the federal judiciary.

This approach, building upon the efforts of former department officials such as Daniel Meador and Maurice Rosenberg, recognizes that what one branch or level of government does affects the others. If the department is faithful to this conception, it will as a matter of course take into account the needs of the judicial branch in terms of resources, structure, and function.

Second, whatever the precise organizational arrangement, the attorney general should underscore the president's commitment by appointing a small staff, devoted exclusively to consideration of the administration of justice, which would work with its counterparts in Congress and the courts to improve the judicial system.

Third, the president should consider ways to make other departments and agencies sensitive to the effects of their work on the administration of justice, most notably the courts. He could require, for example, that an analysis be made of the additional burdens a proposed law might impose on the courts.

The president could also encourage the executive branch, as it drafts legislation, to address matters that if not considered may be left to the courts — questions such as the civil statute of limitations, attorneys' fees, private rights of action, preemption, and exhaustion of remedies. An exercise as simple as conducting seminars on legislative drafting for executive and legislative branch staffs would be very useful.

Fourth, the president should lead the efforts to ensure that the judiciary has adequate resources to do its job. The chief executive should work with Congress, the judiciary, and other concerned parties to depoliticize the compensation issue so that public service becomes an option for a larger pool of qualified people.

The federal judiciary is the best defender of its own interests. But does it not make sense for the president, as the nation's leader, to support a strong judicial branch, one that attracts the best people, that has the resources to make informed decisions and to render justice?

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# *America in the World Economy*

*Barry P. Bosworth and Robert Z. Lawrence*

For much of the post World War II period, the United States was the colossus of the world economy. American living standards were the world's highest, and the United States was often the only source of the products based on the technologies that emerged after the war. Sure of their economic advantage, U.S. business and labor leaders agreed that free trade was in the nation's interest and that prosperity abroad was good for America. The nation's international economic policies were based on the principle of multilateralism: the notion that international economic policies should be used not only to increase American power, but also to open markets for all.

While America was important to the world economy, events in the world economy had little effect on the United States. The greatest threat to America was perceived to be a political one from the Soviet Union. American policy therefore focused on political rather than economic goals — often trading economic advantage, such as access to U.S. markets or technology, for political gains.

Today, America finds itself in a new situation. The postwar economic recovery in other industrial countries has brought their standards of living much closer to those of the United States. The United States offers little that is unique on the production side: American workers do not always have the best skills or work with the most modern equipment. Increasingly, American management has failed to maintain quality, motivate its work force, and make decisions for the long term.

Instead, the importance of the United States rests on the sheer size of its markets and the defense umbrella it provides. It continues to support a large research base, but new technologies are often introduced faster and better in other countries. This change in the relative position of the United States has been gradual, and in many cases it simply reflects an expected return to a more normal international economy.

A second change is of more recent origin and is the result of decisions made at home. In the 1980s the United States has been on a consumption binge, selling assets and borrowing heavily both domestically and abroad. Since 1980 the growth of consumption has far outstripped that of production. In the short run, the experience for many Americans has been a pleasurable one. Tax cuts have bolstered their spending power, cheap imported goods have cut the rate of inflation, and unemployment has fallen to levels last reached in the early 1970s.

The spending spree, however, has been at the cost of a sharp decline in national saving. The net national saving rate averaged only 2 percent of net national product in 1986–87 compared with 6–7 percent in prior decades. The

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country has been spending more than it produces, importing more than it exports, at an annual rate of $150 billion. The resulting trade deficit caused a wrenching realignment of American industry as many companies found themselves priced out of world markets by the sharp rise in the exchange rate of the dollar during the first half of the decade. Increasingly, the pleasures of the spending binge are being tempered by a recognition of its costs: a loss of world markets and the burden of debt placed on future generations.

These changes have damaged U.S. confidence both in the open international trading system and in itself. With the United States no longer in control of the world economy, its politicians often seek to blame trade practices abroad for the costs of the domestic policy changes. U.S. foreign economic policy can no longer be used solely to achieve political goals: it has become crucial to domestic economic well-being. The nation's freedom to control its own destiny is constrained by its position as a debtor country, forced to dance to the tune of its creditors.

During the next decade the United States will face continued pressures from the world economy. It will ultimately be forced to end its reliance on foreign borrowing, accepting reduced growth of domestic spending and further depreciation of the dollar. It will become even more concerned about foreign industrial and trade practices as it struggles to recover lost export markets. Even if it chooses to delay adjustment, it will have to respond to the concerns of foreign investors by offering higher interest rates on U.S. securities or by borrowing in foreign currencies. As foreign debt and interest payments grow, it will have to borrow more or reduce the deficit in the trade account. Delay also places pressure on monetary policy in the short run and ensures that when adjustment does occur, the required shifts in economic structure and spending patterns will be even greater.

As convenient as it is to blame the rest of the world for problems of the U.S. economy, those problems primarily reflect two failings in U.S. domestic policies: excessive consumption and faltering productivity. The growth of the international economy alters the symptoms of those policy failings and complicates the adjustment process but does not change the prescription for recovery: increase national saving and productivity growth. To repeat, the international economy is not the source of U.S. problems. The United States is not disadvantaged by economic growth abroad, it is not the innocent victim of unfair trade practices by others, and its tradable-goods industries do not suffer from a fundamental inability to compete.

## The Issue of Competitiveness

Many believe that American policies toward the global economy must be radically altered. These concerns have reached a fever pitch in the national debate over competitiveness. Some advocate reducing the links between the United States and the rest of the world; others suggest that industrial and trade policies need to be restructured. A common theme is that the United States must abandon its multilateral approach to international economic issues and pursue its own national advantage. Some even suggest a system of managed trade in which the United States uses the lure of access to its large market to extract larger reciprocal concessions from major trading partners.

The discussion is often confusing, however, because the term competitiveness is not well defined. It is important to distinguish between arguments about how well the United States performs in world markets (particularly, the argument that the trade deficit of the 1980s is a symptom of America's inability to compete) and the issues that arise out of the changed relative position of the United States in the world economy.

### Trade Performance

Much of the current concern about trade competitiveness springs from the large trade deficit in the 1980s. However, a trade deficit is a result of a nation's saving and investment, not a measure of its ability to compete in world markets. Even if it is highly innovative and productive and its goods are attractive in world markets, a country whose domestic saving is lower than its domestic investment opportunities must borrow from abroad and run a trade deficit. In 1987, for example, Americans spent 98 percent of their income on consumption, and the remaining 2 percent of income — national saving — was insufficient to finance its investment needs. Thus, it was forced to borrow abroad.

The trade balance tells little about competitiveness because any country can achieve balanced trade if it is willing to lower the price of its products sufficiently. Thus a nation's terms of trade, the price of its exports relative to its imports, are a better indicator of competitiveness. The higher the terms of trade associated with a given trade balance, the better off the country will be.

Adjusted for variations in the trade balance, the terms of trade do show a long-run tendency to move against the United States, but the magnitude of the decline appears to be small — about half a percent annually. Since 12 percent of U.S. income is spent on imports, this decline reduces U.S. living standards by about one-twentieth of a percent annually. The terms of trade were roughly constant in the 1960s, but fell sharply after 1971. That decline can be traced largely to the rise in the price of oil: the price of exports had to fall to earn the foreign exchange to pay for oil imports. By 1980 the United States actually had a surplus of $57 billion in non-oil trade. Since 1980 the terms of trade have improved slightly — but against the backdrop of a large trade deficit. If the United States were to have a trade balance today, the price of its exports would have to be reduced substantially in world markets and the terms of trade would be below the level of 1980.

Those who believe that U.S. competitiveness has suffered advance two major arguments. The first is that American workers cannot compete against workers in low-wage countries. Given the international mobility of capital and technology, they reason, production will go where


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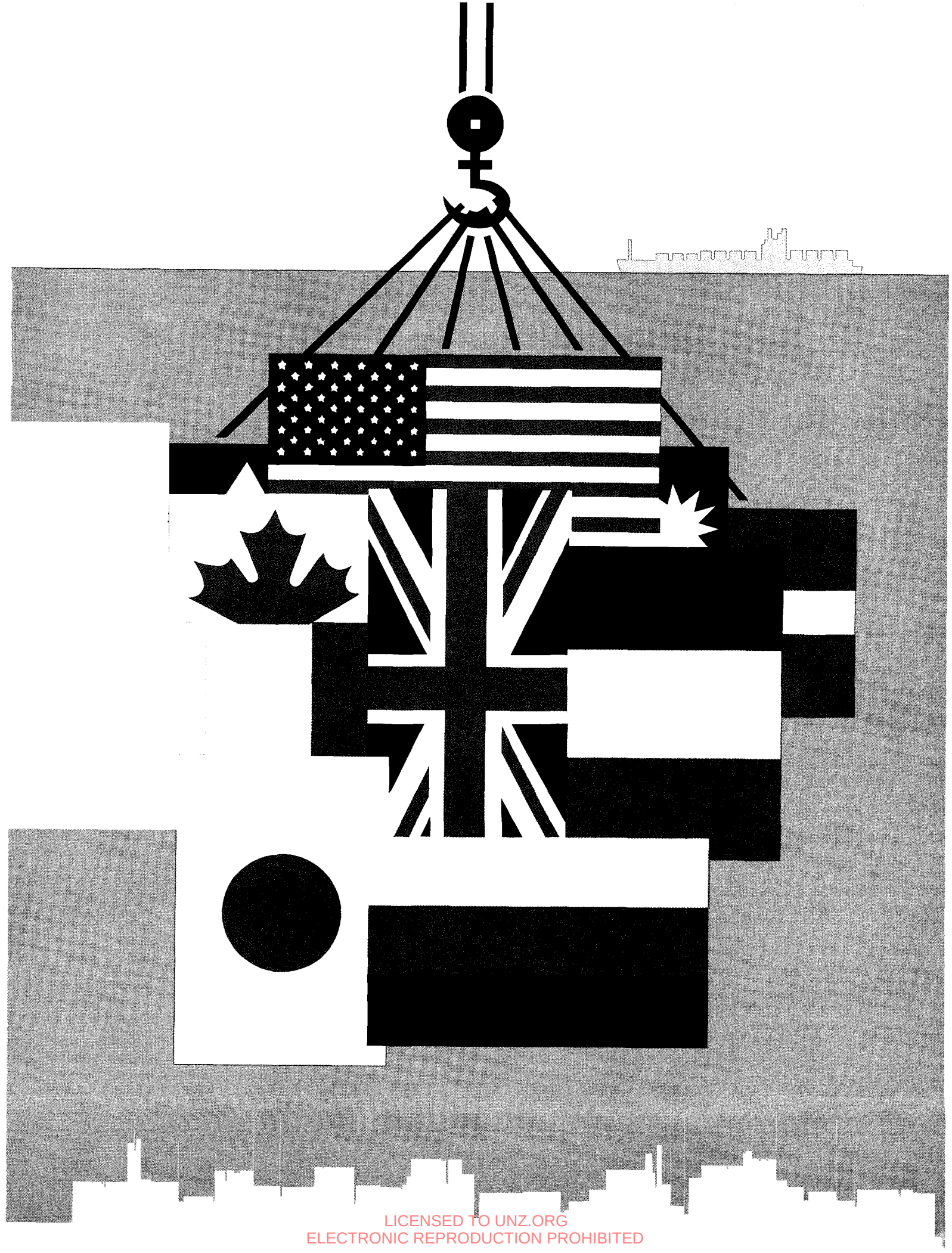

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*"Future improvements in American living standards will depend, as they have in the past, on productivity improvements in the American economy. The welfare of Americans does not depend on the maintenance of poverty abroad."*

labor is cheapest. Economists argue that the spread of technology will bring about a convergence of world living standards as wage rates in other countries rise to the U.S. level. American workers, however, fear that the convergence process is for them one of regression.

The second argument is that the multilateral world that has defined past American trade policy is a myth. The real world is dominated by nationalistic policies that systematically discriminate against imports (through trade protection and selective procurement policies) and target major markets in the United States. The United States should act like other countries and manage trade to its advantage.

The first argument has little empirical support. Imports into the United States are not coming more and more from low-wage countries. In 1960 two-thirds of American imports came from countries with wages less than half the U.S. level. By 1986 their share had fallen to less than one-third. Nor does the emergence of a trade deficit in the 1980s support the argument; the United States lost ground with every major trading area of the world, not just with low-wage countries. Furthermore, the argument ignores the fact that growth in low-income countries expands the market for American exports. In 1987 less developed countries accounted for 34 percent of American exports and 37 percent of imports.

Those who believe that low-wage countries are hurting U.S. competitiveness assume that high American wages can be maintained only by preventing the flow of technology abroad. In fact, American workers are paid high wages not because they have a monopoly on technology but because of their own high productivity, which in turn is based on their education, skills, capital, and technical knowledge. American productivity and living standards are not diminished by improvements abroad. Only about 10 percent of U.S. production, on which those living standards are based, is traded with other nations. Future improvements in American living standards will depend, as they have in the past, on productivity improvements in the American economy. The welfare of Americans does not depend on the maintenance of poverty abroad.

Could the trade deficit be the result of the sudden introduction of trade restrictions by other countries? If so, the effort was well coordinated and worldwide. The United States now has a deficit with every major region of the world, and the increase in the deficit between 1980 and 1987 is roughly proportionate to the volume of trade with each region *(see table 1)*. Furthermore, in recent years the United States has increased restrictions on imports more than other countries have.

Such a sudden deterioration of the trade balance with every region of the globe suggests not worldwide conspiracy but change here at home. That leads back to the collapse of domestic saving. The trade deficit is simply a symptom of a nation living beyond its means: domestic spending exceeds domestic production capacity.

### *Relative Economic Performance*

The relative economic decline of the United States is clear. Its share of world Gross Domestic Product (GDP) has fallen from 27 percent in 1950 to 18 percent in 1984. During that period all six of the other leading industrial countries posted GDP gains relative to the United States *(see table 2)*. Japan's GDP grew from only 9 percent of U.S. GDP in 1950 to 36 percent in 1987. Output per worker in Japan expanded from only 15 percent of that of the United States to 71 percent. The change in relative size, however, does not reflect a failure on the part of the United States, but its success in rebuilding the world economy after World War II. The United States has been joined by many nations with similar technologies, productivity, and standards of living — a return to the situation that existed before World War I. The period after World War II has seen an unparalleled expansion of the world economy, due in part to the opening of world trade and economic relations. Americans shared in that prosperity through a large gain in their standard of living.

Because reconstruction of the world economy was the avowed objective of U.S. policy, its success should hardly be taken as a sign of American failure. U.S. foreign policy failed only if its goal was to maintain American superiority. If the goal was to maximize the welfare of Americans, which is enhanced by rapid foreign growth, relative decline is neither unexpected nor undesirable.

The relative decline of the United States has differing implications for American "power" and for American



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living standards. One base for the power of a nation is its relative economic capacity — the economic performance of the United States compared with that of other nations, particularly its adversaries. In this sense the power of the United States declines in a richer world economy. Conversely, the welfare of a nation's citizens is largely a function of its absolute economic capacity: living standards are primarily based on the nation's productivity, which is increased, not reduced, by trade. Productivity is also raised when increased innovation abroad provides U.S. manufacturers more opportunities to emulate foreign products and processes. When the relative economic performance of the United States is evaluated, the perspective matters greatly: the United States is made less powerful when others do well, but the welfare of its citizens is improved.

**Relative Income and Productivity Growth.** Concern about the relative decline of the economic power of the United States has surfaced at a strange time. The U.S. share of total income of the large industrial countries fell far more before the 1980s than during the 1980s. It dropped from 59 percent in 1950 to 49 percent in 1970. In the 1980s, by contrast, GDP grew as rapidly in the United States as in the rest of the world. U.S. industrial production rose 5 percent faster than the average of all market economies, and the U.S. share of GDP in the seven largest industrialized countries actually increased.

Relative economic growth, however, offers no insight into the more important measure of economic performance — the absolute gain in American living standards. Most of the recent U.S. economic growth is simply the result of rapid growth in the labor force. Except for Canada, labor force growth is much lower in other industrial countries. Growth in the total economy may be relevant to measures of economic power, but it has little relation to improvements in standards of living.

The comparison with other countries is less favorable if the focus is on the growth in productivity, which is most closely related to living standards. Since 1950 growth in GDP per worker in the United States has been consistently below that of other countries, and the rate of improvement has been especially low since 1973 *(see table 3)*.

### *Table 1. U.S. Merchandise Trade Balance, by Region, 1980–87*
*(Billions of dollars)*

| Region | 1980 | 1987 | Change | Share of Total Trade |
|---|---|---|---|---|
| Canada | $ – 1.3 | $ – 12.6 | $ – 11.3 | 18% |
| Japan | –10.4 | – 56.9 | – 46.5 | 11 |
| Western Europe | 20.4 | – 27.5 | – 47.9 | 24 |
| Latin America | 1.3 | – 12.3 | – 13.6 | 16 |
| Newly industrializing countries | – 3.6 | – 34.8 | – 31.2 | 7 |
| Other | –31.9 | – 16.2 | 15.7 | 24 |
| **Totals** | **$ –25.5** | **$ –160.3** | **$ –134.8** | **100%** |
| OPEC countries | $ –38.2 | $ – 13.7 | $ 24.5 | 15% |
| Industrial countries | 9.3 | – 94.9 | –104.2 | 56 |
| Other countries | 4.7 | – 51.7 | – 56.4 | 29 |

Source: Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, vol. 68 (June 1988).

### *Table 2. Relative Levels of Gross Domestic Product, Selected Countries, 1950–87*

| Country | 1950 | 1960 | 1970 | 1980 | 1987 |
|---|---|---|---|---|---|
| United States | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Canada | 6.4 | 7.2 | 8.2 | 9.9 | 10.0 |
| Japan | 8.8 | 14.8 | 28.1 | 33.9 | 36.1 |
| France | 11.8 | 13.3 | 15.8 | 17.3 | 15.9 |
| West Germany | 11.1 | 18.7 | 20.1 | 20.1 | 18.3 |
| Italy | 10.4 | 13.1 | 15.8 | 16.4 | 15.6 |
| United Kingdom | 20.1 | 19.2 | 17.5 | 16.2 | 15.7 |
| U.S. share | 59.3 | 53.7 | 48.7 | 46.8 | 47.3 |

Source: Unpublished data on comparable levels of GDP from Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology.



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*Table 3. Annual Rates of GDP Growth per Worker, Selected Countries, 1951–87*

| Country | 1951–60 | 1961–73 | 1974–79 | 1980–87 |
|---|---|---|---|---|
| United States | 2.0% | 1.9% | 0.0% | 0.8% |
| Canada | 2.4 | 2.6 | 1.3 | 1.0 |
| Japan | 6.5 | 8.2 | 2.9 | 2.8 |
| France | 4.4 | 4.9 | 2.7 | 1.9 |
| West Germany | 5.7 | 4.1 | 2.9 | 1.5 |
| Italy | 5.7 | 5.8 | 1.7 | 1.9 |
| United Kingdom | 2.1 | 2.9 | 1.3 | 1.8 |

Source: Unpublished data from Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology.

*Table 4. Relative Levels of GDP per Worker, Selected Countries, 1950–87*

| Country | 1950 | 1960 | 1970 | 1980 | 1987 |
|---|---|---|---|---|---|
| United States | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Canada | 77.1 | 80.1 | 84.2 | 92.8 | 95.5 |
| Japan | 15.2 | 23.2 | 45.7 | 62.6 | 70.7 |
| France | 36.8 | 46.0 | 61.7 | 80.1 | 85.3 |
| West Germany | 32.4 | 49.1 | 61.8 | 77.4 | 81.1 |
| Italy | 30.8 | 43.9 | 66.4 | 80.9 | 85.5 |
| United Kingdom | 53.9 | 54.3 | 58.0 | 65.9 | 71.9 |

Source: Unpublished data from the Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology.

*Table 5. Differences in Productivity Growth*

| | Percent OECD Exceeds U.S. | | Percent Japan Exceeds U.S. | |
|---|---|---|---|---|
| Years | Total Factor Productivity | Labor Productivity | Total Factor Productivity | Labor Productivity |
| Pre-1973 | 1.4% | 1.9% | 4.8% | 6.6% |
| 1973–79 | 0.8 | 1.3 | 1.9 | 2.9 |
| 1979–85 | 0.5 | 0.8 | 2.0 | 2.5 |

Note: Total factor productivity equals output per unit of capital plus labor.
Sources: Organization for Economic Cooperation and Development, *Economic Outlook*, vol. 42 (December 1987); authors' calculations.

A comparison of productivity growth rates, however, is distorted by the low starting point in other countries. The difference in levels of output per worker calculated using purchasing power parity exchange rates between the United States and other countries, remains surprisingly large in America's favor. In 1987 the average French, German, and Japanese worker produced 14.7 percent, 18.9 percent, and 29.3 percent less than the average American worker *(see table 4)*.

It is far easier to copy than to innovate. In the past foreigners were able to increase productivity by adopting U.S. technologies, while productivity gains in the United States came from pushing out the frontiers of knowledge. As other countries have moved closer to the United States, their rates of productivity growth have tended to decline. The difference between productivity growth in the United States and in the Organization for Economic Cooperation and Development has narrowed since 1973 *(see table 5)*. The difference for total factor productivity growth (output per unit of capital plus labor) declined from 1.4 percent annually before 1973 to 0.5 percent during 1979–85. The differential with Japan narrowed in the same way.

Not all of the difference in productivity growth between the United States and other major industrial countries reflects catch-up. Although U.S. productivity in total manufacturing remains the world's highest, productivity levels in Japan have surpassed those in the United States in industries such as automobiles and steel. In part, that is because foreign economies have been accumulating capital per worker at a more rapid pace than the United States has.

Foreigners are also shifting from copying to innovating. The share of sales spent on research and development by German and Japanese manufacturers is now similar to that of American companies. In the past the product cycle



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originated in the United States and moved abroad. Now innovations cross the Atlantic and Pacific in both directions. According to the National Science Foundation, in 1970 the United States granted 18 and 11 patents to Americans for every 1 granted to Japanese and German nationals, respectively. By 1985, the ratios had declined to 3 and 6.

**Relative Productivity Growth and Trade Performance.** Since 1973 the growth of U.S. productivity (output per hour of labor) has slowed significantly, and the real earnings of American workers have stagnated. Over the same period, the United States suffered numerous shocks from the world economy, including the emergence of a large trade deficit after 1981.

Given the current infatuation with "competitiveness," it is tempting to see causal links between these problems. Many blame the sluggish growth in U.S. productivity and earnings on the changed international environment, particularly unfair trade practices of other countries. Others use what they call a decline in U.S. trade competitiveness to justify greater efforts to raise productivity growth. The apparent link between trade performance and productivity, however, is misleading for two reasons. First, U.S. productivity growth has slumped mainly in sectors that do not engage in international trade. Although individual sectors are difficult to measure, productivity growth in U.S. manufacturing seems to have accelerated in the 1980s. Second, relatively faster productivity growth abroad does not diminish U.S. terms of trade or living standards. During the period before 1973, when foreign economic growth exceeded that of the United States by a wide margin, American living standards grew faster than at almost any time in U.S. history. Furthermore, if higher productivity growth abroad is absorbed by higher wages and profits in these countries, prices will not change, and U.S. devaluation will not be necessary. And if higher productivity abroad results in a lower rate of foreign price increases, reduction in the *nominal* exchange rate might be required to maintain relative prices and trade balance. The decrease, though, would not raise import prices relative to domestic prices in the United States and would thus leave absolute U.S. living standards unaffected.

**International Buying Power.** Differences in the prices of the goods and services produced in different countries make it difficult to compare real productivity and living standards between nations. Our earlier comparisons of relative GDP, adjusted for differences in expenditure patterns and prices between the United States and other countries, suggest that American standards of living are still substantially higher than those of other industrial countries. Yet simple comparisons based on 1987 market exchange rates imply that GDP per employed worker was 11.1 percent, 5.2 percent, and 4.3 percent higher in Germany, France, and Japan, respectively.

These comparisons highlight an important difference between the United States and its trading partners: other major industrial countries have matched or exceeded American performance in tradable goods industries, but they lag far behind the United States in their ability to provide nontradables, primarily in the distribution, food, and services sectors. Their standards of living would be much higher if they could buy nontradable goods from the United States, rather than at home. Because of the high cost of domestic nontradables, these nations, particularly Japan, have much lower overall living standards than their efficiency in producing tradable goods would suggest.

Critics of American economic performance often focus on the manufacturing sector — a proxy for tradable goods. But an improvement in productivity in the tradable goods industries is not necessarily better than one in nontradables. Ninety percent of the goods and services consumed by Americans are produced by Americans. As in the past, Americans' future living standards will depend on the gains in the economy as a whole.

*"Although the United States no longer dominates all areas of the global economy, its ability to raise the living standards of its citizens is not thereby diminished."*

## *Policy Options*

Although the United States no longer dominates all areas of the global economy, its ability to raise the living standards of its citizens is not thereby diminished. There may be less scope for the United States to exercise its will at the expense of others, but economic growth abroad brings with it important benefits to the United States, including a productivity boost from the technological innovations of others, access to larger markets as a producer, and greater variety as a consumer. In the near future, moreover, no other country is likely to approach the importance of the



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United States to the world economy. The United States remains the pivot of the global trading system; its trade flows with both Europe and Asia far exceed those between Asia and Europe.

Over the next decade, the foremost challenge for U.S. economic policy at home is to boost living standards by raising national saving and productivity. The task of U.S. economic policy abroad is to provide an international environment supportive of the adjustments in spending patterns required to achieve these goals.

### *Productivity Growth*

As we argued earlier, the growth in American living standards has slowed because U.S. productivity growth has fallen. One key to future growth in living standards is to restore productivity. Although improvements in productivity will likely improve competitiveness and U.S. trade performance, their primary importance is as a source of gains in the overall standard of living. They are beneficial regardless of whether the nation engages in trade. Moreover, productivity improvements are of approximately equal value in industries that do and do not engage in trade.

Although much of the post-1973 slowdown in U.S. productivity growth remains a puzzle, experts agree on a set of actions that the government could take to reverse the trend. It could encourage a higher rate of private capital formation; it could increase its own investments in the social infrastructure (for example, transportation); it could expand research and development outlays; and it could improve the quantity and quality of education. Government has traditionally played a role in all these areas, but that role costs money. Americans must be willing to reduce their current level of public or private consumption to pay for the steps the experts recommend. In a country already faced with large deficits on its government budget and heavy overseas borrowing, greater spending in these areas will be very difficult to achieve.

None of the actions, moreover, will have large immediate effects on economic growth. They do not, as is sometimes suggested, provide a means for the United States to grow out of the budget deficit.

In the immediate future, the dominant issue for American economic policy is how to cut the growth of consumption, both to eliminate the need to borrow abroad and to provide the investment resources to improve U.S. living standards in the future. From a political perspective slower consumption growth is a dismal prospect, and the extent to which political debate seeks to redirect public attention to the international arena and to blame the policies of other countries should not be a surprise. If the United States lowers its budget deficit, however, it will increase the national rate of saving, and market forces, supported by an easier monetary policy, will translate that saving into a lower trade deficit and a higher rate of domestic investment. Once it has reestablished a balance between its current government programs and the taxes to finance them, the country will be able to engage in a rational debate over the merits of spending more money to promote productivity growth.

*"From a political perspective, slower consumption growth is a dismal prospect, and the extent to which political debate seeks to redirect public attention to the international arena and to blame . . . other countries should not be a surprise."*

A balanced budget would change U.S. policies toward the international economy in two ways. First, the United States would discover a strong interest in promoting a more open trading system—a turn away from protectionism—as it sought to recover its export markets. Second, it would cease its cooperation in international government efforts to fix exchange rates.

### *Trade Policy*

Trade policy has three primary dimensions: ensuring that foreign markets are open to American exports; ensuring that other nations' trade policies do not harm U.S. interests; and helping domestic companies and workers adjust to international competition. In the near term, given the improved price competitiveness of U.S. exports that followed from a lower exchange rate, U.S. policy should concentrate on the first.

There is a growing view that U.S. trade policy goals and objectives should shift to reflect the country's decline in global preeminence. In the 1950s and 1960s, advocates of such a shift suggest, it was appropriate for the United States to fashion its trade policies primarily for the benefit of others and to keep its market open while turning a blind eye to protectionist policies abroad. At that time, they argue, the United States was correct to aim for a system with liberal rules and norms achieved through application of the most-favored-nation principle, under which conces-



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sions granted to one country were extended to all. But today the striving for an open international trading system under the General Agreement on Tariffs and Trade (GATT) rules represents the triumph of ideology over the national interest. Instead, it is contended, the United States should aim for a system of managed international trade, which best serves American national interests by exploiting U.S. leverage to obtain reciprocal advantage.

Advocates of this view stress that the weaknesses of U.S. policies have become most apparent in trade relations with Japan. The Japanese allegedly take advantage of the openness of the U.S. market while reserving local markets for domestic companies. The U.S. response has been to pressure Japan to remove trade barriers in a series of piecemeal negotiations. That policy has engendered much friction between the two nations, and many find the results disappointing. After tough negotiations, Americans often obtain concessions only to find that other barriers remain.

Because interpretations differ so radically over the meaning of the rules, the solution, according to some commentators, is to bargain over results. Essentially that solution implies a regime in which the emphasis shifts toward more managed trade.

Several concrete suggestions about how to implement this new approach have been made. The United States, for example, could determine the largest trade deficit it could afford to run with Japan and then auction off, each quarter, import licenses in the appropriate amount. Alternatively U.S. trade in particular sectors could be allocated along the lines of the international airline cartel. Just as airlines from different nations divide up the traffic between them, so companies from the United States and other nations could divide up the business in any sector.

In fact, the United States already engages in some managed trade. Examples include the voluntary restraint arrangements with the Japanese in textiles, steel, and automobiles, the multifiber agreement, and the Japan-U.S. cartel arrangement embodied in the 1986 semiconductor agreement. But would the widespread application of these principles actually improve the system for the United States?

A managed trade system will afford the greatest benefits to those governments best able to control trade and industrial development — activities to which the U.S. political system is not well suited. Aside from the inefficiencies inherent in such a system, it will not necessarily lead to improved trading conditions for the United States. Managed trade generally involves setting quotas. By limiting the quantity or dollar value of the products or services that a nation can sell in the United States, the United States encourages that nation to charge as high a price as possible. If foreign governments can limit competition for quotas among their companies, they can act like monopolists, maximizing the benefits to their nation.

Japan, in particular, would reap great benefits under such a system. Given a particular dollar value for its U.S. sales, Japan would undoubtedly select products in which it enjoyed either the greatest current benefits (because profit margins were highest) or future benefits (because the products were perceived as high-tech or strategic). Given the ability of the Japanese Ministry of Trade and Industry (MITI) to guide its companies, Japanese strategies would be effectively implemented. Facing similar restrictions, the United States would be much more likely to allocate its products on political, rather than strategic, grounds. Many advocates of a managed trading system believe it would reconcile the differences in national economic systems. In fact, it would expose their contradictions.

A managed trade system reinforces precisely the differences between the United States and other nations that exacerbate trade tensions. When the United States persuades Japan to "volunteer" to limit its sales of automobiles, it vastly increases the power of the MITI to influence the Japanese automobile industry. Indeed, it is the United States rather than Japan that becomes the proponent of Japanese industrial policy.

A managed trade system could be disastrous for some nations, especially smaller and poorer nations with limited bargaining power. These nations now reap the greatest relative benefits from the economies of scale that trade provides. Bilateral negotiations based on power would severely restrict their ability to raise their incomes through specialization. The result would be a more sluggish global economy — a result scarcely in the U.S. economic or political interest.

In a pluralistic world economy the clash of different systems will always produce tension, but that does not imply that trade between nations needs to be managed. A better way to ease tensions is to define practices that are generally recognized as unjustifiable and then to eliminate them. It would be especially inappropriate for the United States to legitimate a system of controls now that market forces are shifting trade trends in its favor. Following the sharp change of the dollar-yen exchange rate in 1986–87, American exports have expanded at a 25–30 percent annual rate; and the Japanese trade surplus, on both a global and a bilateral U.S. basis, has declined dramatically. Trade negotiators, understandably, get caught up in sectoral particulars, but it is macroeconomic conditions, not trade in specific industries, that determine overall trade balances.

It is important to distinguish between the objectives of the trading system — an open system of international trade — and the negotiating techniques for bringing this system about. Traditionally the United States has relied on the GATT and multilateral negotiations. It should continue to do so. At the same time, the GATT itself acknowledges that broad free-trade areas negotiated bilaterally can encourage the long-term trend toward multilateral free trade. The European Community has proceeded in this direction, and recently the United States negotiated a major arrangement with Canada. These measures should continue. Indeed, the European initiative to achieve a high degree of economic integration by 1992 should benefit the United States. First, integration should stimulate European growth, which will in turn raise U.S. exports. Second, it should provide the United States and other exporters with



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a more unified market with common standards. Third, it should undermine nationalistic commitments to protection in individual European countries and thus promote liberalization. Other countries should be alert to the possibility that the initiative could divert trade from countries outside the EC, but the volume is likely to be small.

Despite all the focus on market shares, it should be realized that a rapid expansion of the total world market is the most important determinant of U.S. export growth. Developing countries have always been an important outlet for U.S. capital goods exports. A resolution of their debt problems and a resumption of their investment-led growth would therefore be of great benefit to U.S. exporters. Thus it is a mistake for the United States to view the debt crisis solely from the perspective of its banks. It has become evident that some debt relief will be required, and speedy resolution of this issue is in the interest of American industry.

### *Exchange Rate Policy*

In recent years, the United States has acceded to the demands of other countries that it cooperate in government efforts to control exchange rates. Pressure is increasing to return to an international monetary system where governments fix exchange rates. The interest of other countries is understandable because they wish to maintain their export surplus with the United States. Although the policy is attractive to American consumers, who have no desire to pay higher prices, it could be dangerous to American workers.

If the United States should adopt a tighter fiscal policy, it will risk higher unemployment. One way to counter that risk would be to reduce the trade deficit, so that jobs would shift from industries that do not engage in trade to industries that do. But for the trade deficit to shrink, U.S. incomes must fall (reducing the demand for imports), or foreign growth must expand (raising the demand for American exports), or the prices of American goods must decline in world markets. The first option is highly undesirable, and the second is beyond American control. The third is the strongest balancing force.

Because the U.S. current-account deficit is so large, economists are unable to project the precise change in the exchange rate needed to balance it. The rate will depend on what other countries do to stimulate their domestic demand and on the policies they follow on trade. The United States cannot afford to commit itself, at a time of imbalance, to an exchange rate that may be inconsistent with a future current-account balance and high employment. Without the possibility of a recovery of trade, policies to reduce the budget deficit are likely to translate into higher unemployment.

If the United States does not reduce the budget deficit, the exchange rate may, in fact, rise in the short run. Improved export performance at the current lower level of the dollar, combined with strong domestic spending, may strain the economy's resources and threaten to increase inflation. If the Federal Reserve reacts by tightening credit, U.S. interest rates would rise relative to those of other countries, capital inflows would increase, the exchange rate would go back up, and the improvement in the trade balance would be choked off.

Although the wide fluctuations in the value of the dollar were highly disruptive to the world economy in the 1980s, they should be seen as a symptom of the extreme imbalance in U.S. fiscal-monetary policies, not as a cause of the problems. A return to a system of fixed exchange rates would make deficit countries turn to domestic deflation as the primary means of strengthening their trade performance. Since surplus nations are unwilling to cooperate by accepting higher inflation rates, the system is biased against growth. A fixed-rate exchange system is even more impractical in view of the greatly increased mobility of private financial capital, which necessitates that countries undertake the adjustments quickly.

## *First Among Equals*

In the 1950s, as a dominant and independent economy, the United States could use its international economic influence to achieve political and security objectives. Today, the United States is merely the first among equals in an interdependent world economy. Economic developments abroad, once matters of interest only to foreign policy specialists, are now vitally important to economic performance at home. The emergence of large trade and budget deficits and the transformation of the United States to a large net-debtor country have heightened that dependence. Strong foreign growth not only makes the world less susceptible to Soviet influence, it is critical for sustaining U.S. employment as these deficits are reduced.

While American policies must shift with the changing environment, new policies must be based on a realistic perception of that environment. It is wrong to see foreign growth as damaging to U.S. welfare, to emphasize improving competitiveness over improving productivity, and to abandon the goal of a liberal trading order for a system of managed trade. The future of American living standards overwhelmingly depends, as it always has, on domestic productivity and saving. Given the need to change our policies to achieve these goals, we need an international economy capable of accepting far more American exports and a reduction in the U.S. trade deficit. An exchange rate that makes American products competitive in open and rapidly growing foreign markets will be key elements.

U.S. foreign policy will have to be more creative in an era in which the United States has limited material means. The political battle to restrain spending at home will limit U.S. ability to project influence abroad. Yet U.S. dependence on the international economy has never been greater. The challenge for America is therefore to join in partnership with its allies to build a liberal international system supportive of our mutual interests. While American power may have diminished, the American interest in U.S. leadership has rarely been greater.



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*Harry Harding and Ed A. Hewett*

# *Dealing with Reforms in China and the Soviet Union*

The United States has a substantial interest in seeing economic reforms succeed in the Soviet Union and China. If the reforms take hold, the early part of the next century may witness an expanding flow of competitive products, across a wide spectrum of goods, moving from East to West. Simultaneously the opportunities for Western investment and, more gradually, exports to the Soviet Union and China should improve significantly. Integration of the USSR and China into the world economy would stimulate specialization, trade, and world growth, much as the trade liberalizations in the West did in the 1960s and 1970s.

Beyond the opportunities for trade and investment, economic reforms in the two socialist countries could have significant international implications. China's concentration on economic modernization and reform has already led Peking to seek a peaceful and stable international environment, to build economic relations with a broad range of trading partners, to reduce tensions with most of its neighbors, and to adopt a more flexible and pragmatic approach to many international issues.

The Soviet Union, too, has seemed eager to reduce its international burdens so as to maximize the resources it can devote to *perestroika*, agreeing to the abolition of intermediate- and short-range nuclear missiles, withdrawing its troops from Afghanistan, working for a negotiated settlement in Cambodia, and trying to improve its relations with Peking.

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To be sure, it is possible that in either or both countries, the increased economic and technological resources produced by reform will be devoted to national assertiveness, with each country renewing its drive for major power status. It is also conceivable that reform could stimulate a stronger Sino-Soviet relationship, in ways detrimental to American interests.

On balance, however, the United States has a greater interest in successful reform in Moscow and Peking than in any other likely outcome. If these countries are successful in their efforts to modernize and integrate into the world economy, they are more likely to serve as a force for stability than if they were to continue to develop in a halting, inefficient, and autarkic manner. Moreover, successful reforms would almost certainly require the domestic political and social reforms that Western countries have long hoped to see in the two countries.

The new administration should therefore do all it can to understand the reform process in both countries, make sure it does nothing to hinder its development, and be prepared to take advantage of the new developments as they unfold.

U.S. policies toward the two countries cannot be identical, however. Economically, the Soviet Union is a relatively developed country that conducts most of its trade with the socialist bloc. China is a developing nation whose economic ties are primarily with Japan and the West. Geopolitically, despite recent improvements in Soviet-American relations, the Soviet Union remains the principal adversary of the United States. While China insists on an "independent foreign policy," it shares many common interests with America. These factors imply that American foreign policy can appropriately be more forthcoming toward China than toward the Soviet Union.

China's status as a friendly developing country warrants some degree of technical and economic assistance from the United States. Given the budget constraints now confronting the American government, the United States will probably not be able to offer China large quantities of subsidized credits, as can Japan and, to a lesser degree, Western Europe. But the United States can support capital increases for the Asian Development Bank and the World Bank, part of whose lending is directed toward China.

And China's growing need for economic and technical information can be well served by American educational and commercial organizations with some support from the U.S. government. It is entirely appropriate not only that the United States make such

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*". . . the United States and China would find it beneficial to create the framework for an expanded economic relationship."*

information available to China through academic and technical exchange programs, but also that most of the cost of these activities be borne, as in the past, by the United States.

Beyond that, the United States and China would find it beneficial to create the framework for an expanded economic relationship. For its part, America must continue to relax controls on the transfer of civilian technology to China, permanently extend most-favored-nation status to Peking, revise American trade legislation to reflect China's transition from a nonmarket economy to a regulated market economy, and, once China has entered the General Agreement on Tariffs and Trade (GATT), make China eligible for tariff reductions under the generalized system of preferences.

In return, China must do more to open its economy to American trade and investment. Peking should further improve the climate for foreign investment by allowing the repatriation of profits foreign companies earn in the Chinese market, by offering greater protection to intellectual property, by making all relevant domestic economic regulations available to foreign investors, and by allowing them some access to its economic policymaking processes.

At the same time, Chinese leaders must understand that American investment in and trade with China will be guided primarily by commercial considerations, and that the U.S. government will have only limited ability to encourage those endeavors.

The underlying considerations in U.S. policy toward the Soviet Union differ from those toward China in important ways. The legacy of years of tension in U.S.-Soviet relations cannot be quickly dissipated, even with the best of intentions on both sides. Nor can the two countries quickly get rid of the huge military arsenals that each has built up in its race to best the other.

Aside from this difficult history, it is also a fact that the USSR, unlike China, is a developed country, which eliminates one of the motives behind U.S. willingness to aid China. Clearly reforms in the Soviet Union are moving in a direction favorable to U.S. interests. But Americans cannot and should not treat the USSR as a major political and economic force in the world until the Soviet Union has earned that status. It would be equally foolish for the United States either to attempt to sabotage that effort or to try to pave the way.

As a practical matter, the U.S. government should create a stable atmosphere within which cultural contacts and commercial relations between the United States and the Soviet Union can develop, giving full play to the basic economic and social forces in both societies. The U.S. government should not discourage American businesses from dealing with the USSR, but it need not go overboard in encouraging them. U.S. policy should emphasize that within the constraints of legitimate national security concerns, the commercial merits of proposed joint ventures and similar endeavors, not their ultimate effect on the U.S.-Soviet relationship or on Soviet society, should be the main consideration. If American entrepreneurs are convinced these ventures will be profitable, they should go ahead with them.

As the Soviet Union continues its efforts to join in the work of major international economic organizations, the United States should indicate that it is willing to talk, and willing to be convinced. The USSR will, for example, soon be applying again for membership in the GATT. The U.S. reply to the first Soviet overture to the GATT in August 1986 was a flat no. This time around, the United States should agree to negotiations, the basic thrust of its position being that if and when the domestic reforms really take hold, Soviet membership in the GATT might well be workable — but not until then. In addition, the United States must be sure that the Soviet Union is genuinely interested in making the GATT work, rather than using it solely to make points about the relations between developed and developing countries. The U.S. government should adopt a similar willingness to listen if and when Soviet leaders express more than a modest interest in membership in the Asian Development Bank, the International Monetary Fund, and the World Bank.

In both China and the Soviet Union, U.S. influence will be modest. That influence is primarily inadvertent, a product simply of the existence of our economic and political system. For Soviet and Chinese leaders, the dynamism of the United States is an important spur to their efforts to reform. Beyond that, the U.S. ability to influence the reforms through consciously designed policies is limited, as are the resources that might be brought to bear.

The most important thing the administration can do is make sure it understands the reform process in both countries. It must be able to sort out apparent from real changes if it is to calculate the effect of developments there on U.S. interests. Then with all the skill it can muster, it must judiciously apply the resources and influence it has to support positive trends in the two societies.

*"The U.S. government should not discourage American businesses from dealing with the USSR, but it need not go overboard in encouraging them."*



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*Philip H. Trezise*

# *What Next With Export Controls?*

For more than 40 years the United States has sought to deprive the Soviet Union and its allies of access to goods and technology considered to be related to Soviet military potential. The principle underlying that policy has wide acceptance. The practice is and has been controversial, at home and abroad.

Congress now has taken a hand in the controversy, in that extraordinary exercise in micromanagement, the Omnibus Trade and Competitiveness Act of 1988. Next year the White House will have to decide how to deal with a much amended export control law, one that seeks primarily to liberalize U.S. administrative practice but that also proposes to inflict dire penalties on foreign companies found to be violating restrictions on exports to Eastern Europe.

The source of the difficulties with security export controls is easily identified. From the beginning, the stated policy has been to restrict only the export of things that would "materially aid" the Soviet military buildup. A 1951 act imposed an embargo on exports of "arms, ammunition, and implements of war" and of "atomic energy materials." These categories have caused no real complications. Virtually everything else has.

Most of the trouble has involved products having both civil and military applications. Ball bearings are found in civilian and military vehicles alike. Machine tools for producing textile machinery may be used to make tank components. A computer supposed to be installed in a Moscow statistics bureau may be diverted to the strategic nuclear forces. Telephone switching equipment could aid Warsaw Pact mobilization. Decisions in cases like these are likely to rest on judgments about fine degrees of security risk. One longtime member of the U.S. export control bureaucracy has termed such decisions "inevitably subjective and arbitrary."

In the early years of the cold war, the United States circumvented the problem by maintaining a near total embargo on exports to the Soviet Union and an only slightly less complete ban on exports to Eastern Europe. Western Europe and Japan, however, were wholly unwilling to engage in what they regarded as economic warfare or, put less kindly, to forgo commercial opportunities in the East.

By the mid-1950s the U.S. government had recognized that its unilateral embargo made little sense and began gradually to reduce the scope of its controls. Still, the U.S. list of restricted items remained longer than anyone else's. To this day, the United States maintains a list of controlled exports that includes but goes well beyond the list agreed to by the COCOM, the 15-nation export control grouping.

This differential approach has had a number of consequences. Critics attribute to American intransigence a COCOM control list said now to contain many items no longer of strategic significance. Periodic reviews to weed out those items have not been effective, understandably so since each participant has a veto over removal of each specific item.

Only the United States has insisted that it must approve the export of U.S. origin products or their components if they are to be reexported to another country, whether free world or not. Enforcement of this unilateral licensing requirement has been contentious with COCOM and non-COCOM countries alike.

American exporters have been equally unhappy, if not more so. They say reexport licensing puts them at a competitive disadvantage: not only does the process lead to lengthy delays, but it also makes customers abroad chary of entering into business arrangements that may entangle them in unpleasant ways with U.S. laws and regulations.

With the widening spread of advanced technology, foreign availability of controlled items promises increasingly to cut into the efficacy of U.S. and, for that matter, COCOM controls. For the past five years the Department of Commerce has been urged to decontrol items that are available uncontrolled from other countries. The results have been meager because of interagency differences.

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Management of export controls has been a recurring source of bureaucratic infighting. Defense, Commerce, and State have been the principal departments involved. Defense, unsurprisingly, has advocated tight controls on a wide range of goods. Commerce's ties to the business community have made it a supporter, sometimes a cautious one, of a shorter control list and fewer burdensome rules for exports to Western destinations.

For State, the controls have plagued relations with allies almost from their beginning. State officials believe the solution lies in a single set of controls agreed to and enforced multilaterally. The departmental divisions have never been overcome, least of all, perhaps, by the current administration.

These differing positions have been mirrored in Congress, but on a shifting basis. Exports to the Soviet Union (and until recently to China) periodically have called forth patriotic oratory whenever the political environment made trade with the putative enemy an appropriate target. At other times, and this is one of them, complaints from the export industries, led now by the high-tech sector, and unease about gridlock within the executive branch have swung congressional opinion toward a more relaxed policy stance.

For a vehicle Congress had the omnibus trade bill, written by 20 or so committees and covering ground far beyond the scope of any prior trade legislation. Export controls fell to the House Foreign Affairs and the Senate Banking committees, which proceeded to redo the Export Administration Act in response to a variety of perceived large and small shortcomings in its operation.

Henceforth, licensing is to end for most goods destined for reexport within the COCOM group or to certain other nations. Licensing generally is to be reduced, looking to the goal of an "export license-free zone" among cooperating countries. The executive branch is told to pare down the U.S. control list.

To deal with alleged Defense Department obstructionism, Commerce is directed to ignore views of other agencies in determining the facts about foreign availability. Defense review of license applications is to be concerned with security, not foreign policy, considerations. Defense must decide within 20 days whether to appeal a licensing decision to the White House. And the president no longer need report to Congress if he rejects a Defense recommendation.

After this and much more, Congress turned to export control violations, having much in mind the well-publicized Japanese and Norwegian exports to the Soviet Union of submarine propellor technology. Future foreign violators of COCOM regulations face a ban on exports to the United States. If the president finds the violation to have had "a serious adverse impact on the strategic balance of forces," he is to seek compensation for increased defense costs by negotiation or by suit in a U.S. court. The next administration will have to hope that this law will indeed deter violations, else difficult times with our allies lie ahead.

*"For the controls to be made less burdensome on American exports . . . the White House will have to take a decisive role. . . ."*

Nevertheless, the chief objective of the new legislation is to loosen U.S. security export controls, by means of detailed guidance to the executive branch. Yet uncertainties are bound to persist. And so will differences with other governments, unless the U.S. position on export controls changes more radically than the congressional directives require. For the controls to be made less burdensome on American exports and more acceptable to our COCOM partners, the White House will have to take a decisive role in the administrative process.

Provisions in the legislation show why that is so. Consider that there is now written into national law a "presumption" that goods sent to China for a trade promotion exhibit should thereafter be exportable. Or that the Customs Service is now barred by statute from "detaining" for more than 20 days goods eligible for export under general license, that is, essentially uncontrolled. It seems clear that the Reagan administration was not able or did not choose to impose discipline on the departments concerned.

If the next president decides that the U.S. interest is to stay with more restrictive controls than other countries, the changes mandated in the omnibus bill will not prevent him from doing so. If he elects to change past policy, however, he can find support in the legislation. In that case, his best approach would be to accept the implicit invitation to phase out differential U.S. controls and to negotiate a less extensive COCOM list in return for allied commitments to enforce effectively an embargo on products that all can agree have a substantial bearing on Soviet military potential.

This approach involves a tradeoff. A control program that is nominally comprehensive but that American export sectors think has been needlessly damaging and that has been a continuing cause for international discord would be exchanged for a set of tighter controls aimed directly at slowing and otherwise making more expensive the strengthening of Soviet military capabilities. In principle, these controls would be consistent with the widely desired improvement in relations with the Soviet Union. Opponents of liberalization would have the prospect of more enforceable and more sharply targeted restrictions on the transfer of military-related technologies.

Nothing like that will happen without presidential leadership. If, as the omnibus trade act says in 25 single-spaced pages, the current system has been costly and ineffective, the principal reason is that there has been no reconciliation of divergent opinions within the U.S. government. The president can do the reconciling, but only if he is prepared to define an administration policy and to insist on its being carried out.



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# The Prospect of Cooperative Security

*John D. Steinbruner*

The United States is struggling these days with the consequences of its own success. Having encouraged strong industrial democracies in Germany and Japan, we are straining to adjust to their economic competition. Having supplied the world's major operating currency and attracted its investors, we are now working to service a large accumulated debt. And having long promoted abstract ideas of cooperative security, we now face the practical implications of the fact that our principal adversary appears to be taking them seriously.

The "new thinking" advanced by Mikhail S. Gorbachev as leader of the Soviet Union presents a conception of Soviet security strikingly different from that of the past, and one unmistakably resonant with earlier Western ideas. If appropriately developed, the new line of Soviet security policy would materially improve international security and reduce the military requirements of Western defense.

As presented in official and semiofficial pronouncements, the new conception of Soviet security gives overriding priority to the objective of preventing war. In and of itself, that priority is not particularly remarkable or particularly new. The prevention of war has long been the Soviets' fundamental declared intent, as it has been for the United States and all other major powers since the advent of nuclear weapons. But even the incomplete explanations offered so far make clear that the new declaration is meant to convey a notable shift in perspective — a different diagnosis of the security problem, different conclusions drawn from that diagnosis, and ultimately a different security posture. The shift reflects tensions created by modern weapons technology to which the Soviet Union is unusually sensitive.

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## Policy Tensions

The universally acknowledged purpose of modern military forces equipped with nuclear weapons is to deter a calculated attack by threatening effective retaliation. That is the primary means by which the Soviet Union and all other states that have nuclear weapons propose to prevent major war. These weapons are so destructive, however, and their means of delivery so fast, that no prudent military organization can be confident that it can meet the strict demands of retaliation. If either of the principal strategic establishments allowed the other to complete a first strike, the effectiveness of subsequent retaliation would be very uncertain. In all probability, a sufficient number of weapons would survive, but the command and control arrangements to direct their use might not. That problem is of particular concern to the Soviet Union, where military operations are conducted under strict and extensive central control.

To make the deterrent threat credible, both strategic organizations have prepared for a retaliation rapid enough to complete the basic command functions — authorization



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and coordination — before a first strike could be fully executed. The distinction between initiation and retaliation thus reduces to a few minutes. Given that strategic forces operate on a global scale and that widely dispersed reconnaissance systems generate massive flows of information between the two organizations, the distinction might not be preserved at all.

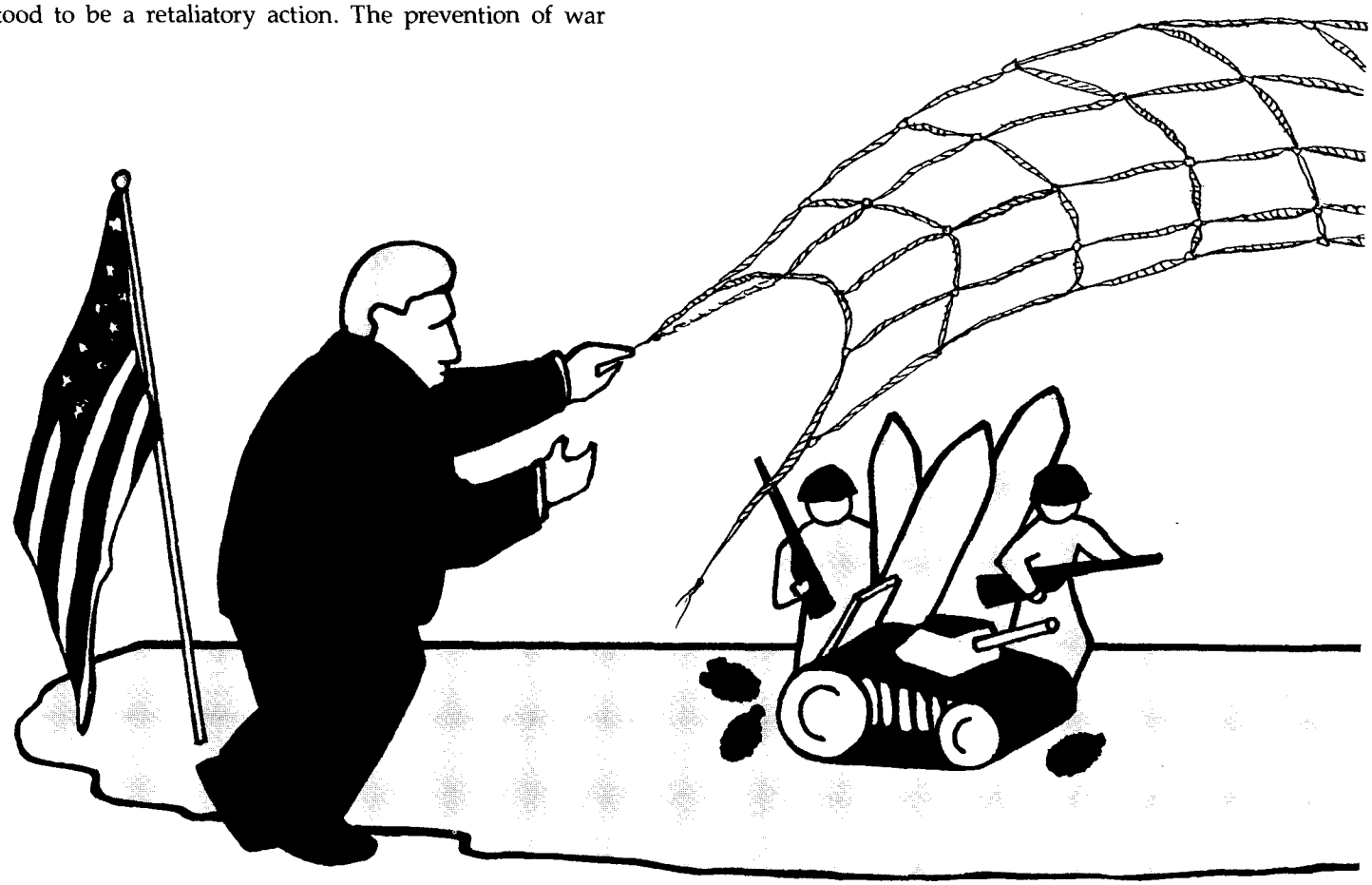
That problem is of particular concern to the Soviet Union. In conducting military operations, just as in managing economic production, strict central control inevitably slows responsiveness to the flow of information. Judging from normal peacetime practices, the Soviet Union exercises centralized control over a much broader range of operational activities than the United States does and maintains its military establishment in a state less ready for combat. The United States maintains strict central control over the authority to use nuclear weapons but disperses the authority to maneuver them and maintains a higher state of readiness. Though no intense crisis has occurred to confirm it, the Soviet military forces would appear to compare to those of the United States as a marathon runner compares to a sprinter — a distinct disadvantage if the competition in question is a hundred-meter dash.

Inherent in this situation is some possibility that a crisis not deliberately initiated or effectively controlled by either side could produce an unintended war, even though all parties involved remained convinced that war would be disastrous. Such a catastrophe could occur if protective alert procedures of the two sides triggered what each understood to be a retaliatory action. The prevention of war therefore requires not only a strong deterrent effect but also effective control of force interactions. A crisis would produce extreme tension between these two imperatives; and, again, that tension appears to be disproportionately dangerous for the Soviet military establishment.

## *Soviet Adjustments*

As nuclear weapons were developed and deployed, Soviet security policy adjusted the balance between those competing objectives several times, most notably in a doctrinal shift initiated in the middle of the 1960s.[1] Before that time, when Soviet deployments were smaller in number and less protected than those of the United States, Soviet military doctrine had declared that the use of nuclear weapons would be an unavoidable consequence of any major war, a conclusion that justified an explicit preemptive strategy. The Soviets had committed themselves to detecting an impending strategic attack before it was actually under way and to initiating retaliatory operations before they could confirm missiles and bombers in flight. In other words, the marathon runner would have to jump the gun to have any hope against the sprinter.

That commitment entailed an obvious risk of misjudgment, but it offered some protection against a critical vulnerability. If Soviet forces of that period had conceded the initiative and had suffered the full effects of a U.S. attack, their ability to retaliate would have been doubtful.





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By the mid-1960s the Soviets had reduced the vulnerability of their strategic forces by increasing their numbers and providing more extensive measures of protection. At that point, when effective strategic parity was in prospect and NATO was formalizing its flexible response strategy, the Soviets altered their official doctrine to admit the possibility that a major war might be waged, most notably in the European theater, without any use of nuclear weapons. Though somewhat skeptical about the feasibility of such a restrained war, they accepted the prospect as a planning contingency and admitted as a corollary that if it occurred they would not initiate the use of nuclear weapons against the United States. Hence, in that instance, they could not execute their previously established doctrine of strategic preemption even though a war in Europe would provide the primary warning evidence on which the decision was to be based.

Carrying out the revised logic, the Soviets set a requirement for their conventional forces to engage in rapid, decisive, offensive operations against Western Europe in the initial stages of such a war, in effect transferring the preemptive strategy from nuclear weapons to conventional forces. If they did not win quickly in Europe, they calculated, they would surely lose eventually because of superior American economic and technical potential.

This doctrinal shift was implemented by a surge of investment in Soviet conventional forces that ran from the late 1960s through most of the 1970s. The sustained investment substantially improved the ready capability of Soviet conventional forces. It also spurred NATO to make a greater investment in its forces, particularly in the application of advanced technology for attacking the infrastructure of Soviet forces far behind the immediate battlefield. Because that capability was designed to stop the planned Soviet advance into Western Europe by stopping the forward movement of reinforcements, it also would have to be used in the earliest stages of war.

The net effect of the mid-1960s doctrinal change, therefore, and of the operational configuration of forces that emerged from it, was to impose on conventional forces the pressures for rapid action and the resulting volatility under crisis conditions that Soviet planners had sought to remove from nuclear forces. Since conventional forces on both sides in the European theater were extensively equipped with nuclear weapons as well and inclined, at least on the Western side, to use them early in the course of any major engagement, the adjustment of the 1960s did not resolve the underlying problem but may have even aggravated it by attaching to the nuclear arsenals a conventional fuse that was easier to ignite.

The current shift in Soviet operational doctrine is more radical. Preemption is no longer to be a strategic option and the occurrence of global war is no longer to be the central contingency of general security planning. To maximize the chances of avoiding war, as distinct from those of winning it if it does occur, Soviet forces are to be put in a more defensive posture. Nuclear forces are to be sized and configured strictly to retaliate and conventional forces

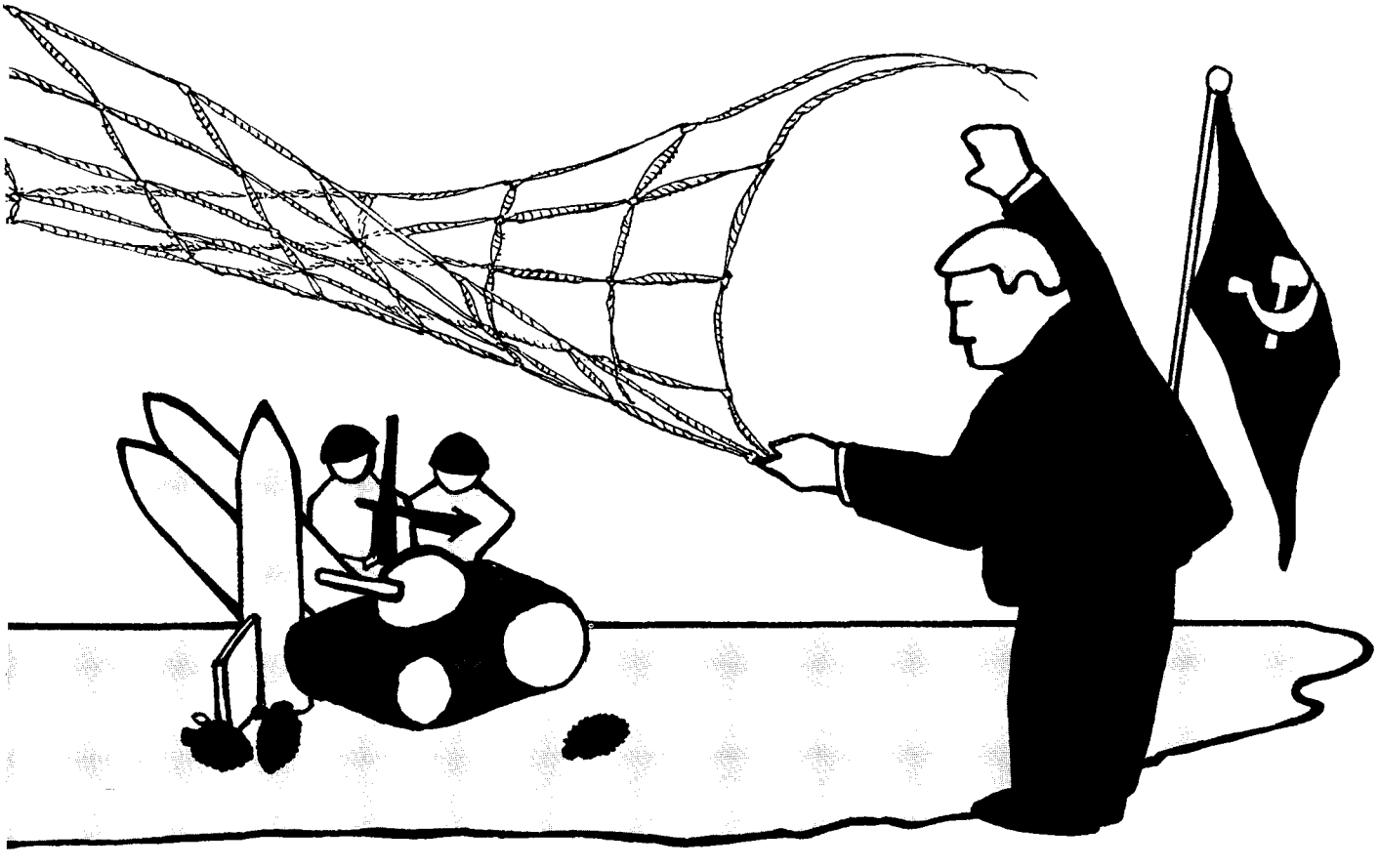

Illustration by Regina Jones



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strictly to hold their positions. Overall security, moreover, is not to rely solely, or even primarily, on unilateral military action but rather on international cooperation.

The calculus implicit in these principles accepts some risk about the potential outcome of a war in order to increase the likelihood that war will not be initiated. It assumes that there is no inexorable reason for war between the Warsaw Treaty Organization (WTO) and NATO and that Soviet national security can safely rest on the expectation that major war will be indefinitely avoided. It also assumes that maintaining deterrence is a less urgent security problem than maintaining control of the interaction of forces. These assumptions make stability the central consideration in managing the balance of military forces. They also shift the element of initiative in security policy entirely into the realm of diplomacy. Initiative on behalf of Soviet state security is to be undertaken in advance of crisis and is to focus on reducing tension between NATO and the WTO and on resolving, or at least containing, regional conflicts outside of Central Europe.

### *American Reactions*

At their current state of abstraction and completeness, these Soviet doctrinal developments are unlikely to be convincing to the United States. Most Americans heavily discount any Soviet statements of constructive intent; for some it is virtually axiomatic that such statements are deliberate efforts to deceive.

The United States, moreover, does not vest doctrinal prescriptions with anything like the significance they have for the Soviet planning system and could not readily respond in kind even if there were a general willingness to suspend disbelief. The natural American reaction is to await specific results with polite but skeptical interest, imposing on the Soviets the burden of proof much as a judge would do to a plaintiff making an extravagant claim.

The problem with that reaction is that the United States itself must be involved in any systematic implementation of the Soviet doctrinal developments. Though the new line of Soviet policy clearly implies a large reduction and restructuring of military forces, the Soviets are unlikely to make such changes unilaterally. NATO and the WTO have so formalized their security requirements in reference to the other that the design, the scheduling, and the specific implementation of structural reform is now a mutual affair.

Disengaged skepticism, moreover, does not accord with American interests. The need to reduce the federal budget deficit will almost certainly result in lower defense budgets, a fact that raises the U.S. stake in mutually organized restraint on military forces. Although traditional security commitments can be preserved despite a declining defense budget, that effort requires much stronger discipline in the internal allocation of resources than the U.S. political system has ever been able to produce *(see p. 63)*. Such discipline is unlikely to be achieved unless the related discipline of integrating force posture and arms control arrangements is also pursued.

In addition, for some U.S. allies — most notably West Germany, population dynamics compound financial pressures on the defense effort. The number of people eligible for military service in the Federal Republic will decline by 41 percent from 1987 through 1995, a stark fact that dictates an undeniable interest in force reductions. Passive skepticism about Soviet doctrinal initiatives and defensive reaction to the diplomacy emerging from them are simply not consistent with maintaining a leadership position either in NATO or in other alliances. If the United States does not muster both the wit and the will to shape the outcome of a cooperative security arrangement, its international stature will assuredly decline.

For all these reasons the combination of opportunity and challenge inherent in the emerging Soviet security conception exerts powerful pressures on U.S. policy. By themselves, these pressures may not be sufficient to compel new lines of American thought, but they do create the condition for new assumptions to take hold and for a new synthesis of American interest to form.

## *Potential Outcomes*

Both the logic of the emerging Soviet security doctrine and the force structure that would result have been outlined in the course of exchanging arms control proposals. The Soviet agenda was set forth in appeals for conventional force reductions in Europe issued by the WTO in June 1986 and May 1987, and in a program for strategic force reductions presented at the summit meeting in Reykjavik, Iceland, in October 1986. Together the two initiatives suggest a comprehensive regulation of the military balance that would make it much more consistent with the new security conception than it now is.

The U.S. and allied response to these initiatives has been rather contentious in tone and sluggish in timing, but it is not as negative as immediate reactions would suggest. One part of the Reykjavik agenda — the elimination of intermediate-range nuclear weapons — has been formalized in a treaty and is being implemented. That accomplishment has imparted some momentum to the remainder of the program.

Apart from that treaty, the details of the projected arms control arrangement have not been completely specified; the conventional force initiative is particularly vague. With some simple logic and a little common sense, however, the potential outcomes can be inferred. The intricacies of bargaining maneuvers, political disputes, and bureaucratic staff work introduce great uncertainties about the timing of arms control arrangements, but in the end the results are largely determined by underlying national interest powerful enough to be both decisive and apparent.

### *Strategic Force Reductions*

One thing apparent is that the number of nuclear weapons deployed on both sides did not result from any coherent calculated plans, but from a sequence of political decisions



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whose net results did not conform to any of the many participants' earlier intentions. Relating the size of the arsenals to the strategic purposes they are meant to serve has largely been an exercise of rationalization after the fact, and it is not surprising that the exercise has inspired attempts to revise the original decisions. In exchanging proposals for 50 percent reductions in strategic forces, the United States and the Soviet Union are tacitly conceding that their current deployments exceed essential deterrent requirements.

An exact measure of these essential requirements has never been officially proclaimed, in part because it is difficult to form a consensus and in part because it would be awkward to admit candidly that any reasonable measure would fall well below existing deployments. Given the obvious vulnerability of military organizations and industrial societies to the effects of nuclear weapons, however, there is little mystery about the limits of what could be considered essential. In both the United States and the Soviet Union, roughly 70–75 percent of industrial capacity is contained in 1,500 circular areas over each of which a single weapon could spread lethal blast and thermal effects. Attacking any substantial number of these targets would devastate both the society and the economy of the victim. The same number of weapons could eviscerate the infrastructure of either military organization, and the targeted military installations overlap with urban-industrial targets. If deterrence works at all, it would presumably work at these levels of threat.

Moreover, as a practical matter, adding yet more weapons to a theoretical retaliatory attack does not add much to its functional consequence. The first 1,500 to 2,000 weapons would so severely damage the military and industrial organization of either country that additional pounding would simply waste offensive assets. Whether the purpose is to punish an aggressor's society or to incapacitate its military establishment, 2,000 is about the limit for the number of nuclear weapons that can be used efficiently.

The presence of more than 10,000 weapons in each of the deployed arsenals has been justified by the idea that there is safety in numbers. Both sides claim that deployments larger than actually required for effective retaliation are necessary to ensure that enough weapons would survive an initial attack. That theory of protection, however, inevitably produces reciprocal fears of preemption, since the excess capacity could also be used to initiate an attack.

Trends in strategic weapons modernization have compounded the problem by emphasizing advances in offensive capability (largely the accuracy of delivery and weapons yield) rather than improvements in protective measures. In particular, two of the principal new U.S. weapons programs — the MX ICBM and the Trident II submarine-launched ballistic missile — are no more protected than the weapons they replace, but they are a much greater threat to the hardened silo installations that constitute the bulk of the Soviet strategic force.

An obvious way to stabilize the strategic balance, therefore, and to tailor it to the new security conception is to remove the excess offensive capability on each side, in effect substituting regulation for redundancy as a method of protection. That could be accomplished by reducing deployed forces to a level near the ceiling for efficient retaliation and by limiting modernization to measures that shelter weapons from direct attack. Under such arrangements neither side could initiate an attack on the opponent's strategic weapons without weakening its ability to cover the industrial and military infrastructure targets that embody the deterrent effect. Moreover, if the number of warheads are limited relative to the number of missiles and aircraft that carry them, there are several designs for protecting deployed missiles that would make this trade-off with the basic deterrent requirement prohibitively severe.

Though it has not yet been clearly articulated in formal negotiations, this distinction between an essential deterrent requirement on the one hand and preemptive attack capability on the other is fundamental to the design of an enduring strategic force reduction agreement. The legitimacy of a deterrent capability must be conceded as the only acceptable justification for those weapons that are allowed. Neither side can responsibly concede the legitimacy of a preemptive attack capability, and the denial of that capability is the main reason for undertaking strategic force reductions.

In practical terms the distinction denotes different types of targets. Those installations necessary to conduct general military operations would presumably be included in the essential deterrent requirement against which a retaliatory deterrent threat is accepted. Strategic weapons launchers and their immediate command facilities would presumably be excluded from that requirement, and the capacity to attack such targets would be limited to the greatest extent practical.

## *A Design for Defensive Deterrence*

The principle of protecting deterrence and denying preemption cannot be translated into a level and configuration of strategic forces with mathematical precision. But the basic design of forces that would approximate that criterion can be derived by applying the standard parameters used to measure the effect of weapons — number, yield, accuracy, reliability — and the standard model used to simulate the exchange of forces having these characteristics. Such calculations can hardly predict the realities of an actual war, but they do embody institutionalized expectations in both the United States and the Soviet Union. It is these expectations that the deterrent threat is meant to influence.

Brookings and the Lawrence Livermore National Laboratory recently used a simulation model embodying these standard calculations to compare current strategic forces with those that might result from agreed reductions.[2] Each side was first assumed to have inventories of 10,000 weapons, roughly the number available under current levels of deployment. The model assigned weapons to



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targets to achieve the maximum expected effect and then calculated a probable result. The assessment indicates that a Soviet attack on the United States would use approximately 4,000 weapons to destroy more than 7,000 U.S. warheads but would leave 2,900 U.S. warheads available for retaliation. A U.S. attack on the Soviet Union would use 4,400 weapons to destroy 8,300 Soviet weapons, but 1,700 Soviet weapons would survive to retaliate. The exchange ratios — 1:1.8 for the Soviets and 1:1.9 for the Americans — favor the attacker as do the balances of remaining weapons — 2.1:1 for the Soviets and 3.3:1 for the Americans. The U.S. force performs somewhat better than the Soviet force.

A second simulated exchange assumed that forces had been reduced to 3,000 warheads on each side and configured for maximum protection. The most effective preemptive strike weapons — the U.S. MX and prospective Trident II missiles and the Soviet SS-18 — were removed, and each side was assumed to have deployed 1,000 single warhead ICBMs in a mobile basing mode.

If the attacker completely surprised the victim under that configuration, the first few hundred warheads would destroy nearly 1,000 submarines, bombers, and ICBM warheads not on alert. But thereafter the efficiency of the attack would decrease to such an extent that it could not be pursued without the attacker being disarmed and the victim left with more than 1,000 warheads for retaliation. In contrast to the first scenario, the exchange ratios and residual force ratios flip in favor of the defender, as the central principle of protecting deterrence and denying preemption would require. Moreover, there is simple equity in the fact that at the reduced level U.S. and Soviet forces appear to perform equally well.

In this assessment, essential retaliatory requirements are adequately covered at both the 10,000 and the 3,000 warhead levels, demonstrating that the strong existing deterrent effect would not be materially diminished by even a drastic reduction in forces. The main consequence of such a reduction would be to change from positive to negative the incentive to initiate a preemptive strike.

From the perspective of deterrence theory, that change appears to be of little practical significance as long as an adequate retaliatory capacity seems ensured. But from the perspective of crisis control, which the Soviets are apparently trying to advance, the significance is much greater. As long as an incentive to preempt exists by these methods of assessment, both sides in their prepared plans will assign available weapons to attack strategic weapons targets, and the operating forces will train to complete these missions as rapidly as possible, since they make little sense unless the timing is preemptive. That feature of planning combined with the basic threat to the integrity of the command systems creates much of the impulse for preemption that could be exceedingly dangerous in a crisis.

A reduction and reconfiguration of forces along the lines of the 3,000 warhead example described here would decrease this impulse. For both sides that fact is probably significant enough to impose its logic on an eventual strategic arms agreement.

## *Conventional Force Limitations*

In keeping with the principle of preserving deterrence, a strategic force with 3,000 warheads would give the United States ample capability to threaten a limited number of targets, whose destruction nonetheless would make an invasion of Western Europe infeasible. Strictly in terms of military capability, therefore, the strategic force reductions would not significantly decrease the particular threat U.S. strategic forces pose to conventional aggression in Europe. But the reduction undoubtedly would diminish political confidence among members of NATO.

Throughout its history, the alliance has believed that its conventional forces could not withstand a full WTO assault, and its European members have openly doubted whether the United States would use its strategic weapons to defend them if it was not under attack itself. In the late 1950s, after the Suez crisis and the launch of Sputnik had crystallized European misgivings about U.S. strategic protection, NATO supplied its forces with thousands of nuclear weapons, whose presence in the area of potential conflict was accepted as a political guarantee that more remotely located forces could not provide. The greater vulnerability of these NATO forces was discounted in the strategic calculus, but it affected the operational posture that evolved. For more than 30 years NATO has ingrained in its commanders a strong inclination to use their nuclear weapons early in the course of a major battle. That traditional inclination would be strengthened if strategic force reductions were not accompanied by a reduction in the apparent threat of invasion, and would eventually be manifested in a politically charged program to modernize the tactical nuclear weapons arsenal.

That sequence of events would reinforce the countervailing strategy the Soviet Union adopted following its adjustment in doctrine in the 1960s and thus contradict its new security concept. Over the past decade Soviet tactical air forces have been concentrated in forward positions, with an evident intention to conduct a conventional air interdiction campaign against NATO's nuclear weapons. Such a campaign would be much more effective if it began just as NATO began to move its tactical nuclear weapons from their peacetime storage areas. But in the midst of a crisis, Soviet commanders would face a severe burden in judging whether the movement of those weapons indicated a commitment to use them or simply a desire to protect them from attack. The burden would fall on NATO commanders if they did not move to protect their weapons. This tension between the operational postures of the two alliances — one of the more likely triggers of an unintended war — would be even worse if an agreement on strategic weapons increased reliance on tactical nuclear weapons.

Cooperative security therefore requires not only that Soviet conventional forces be put into a more defensive posture, as the new Soviet operational doctrine demands, but also that NATO subordinate its reliance on tactical nuclear weapons to plans for a strictly conventional defense of forward positions. From the perspective of deterrence,



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## *Table 1. Conventional Force Comparisons*

| | NATO | WTO | Ratio WTO: NATO |
|---|---|---|---|
| *Total military manpower* | | | |
| High estimate | 3,000,000 | 4,000,000 | 1.3 |
| Low estimate | 2,385,000 | 2,292,000 | 1.0 |
| Mean | 2,696,300 | 3,573,000 | 1.3 |
| *Main battle tanks* | | | |
| High estimate | 22,200 | 54,300 | 2.4 |
| Low estimate | 13,500 | 32,400 | 2.4 |
| Mean | 19,000 | 47,000 | 2.5 |
| *Armored vehicles* | | | |
| High estimate | 38,400 | 94,800 | 2.5 |
| Low estimate | 28,900 | 42,000 | 1.5 |
| Mean | 33,400 | 68,400 | 2.0 |
| *Anti-tank missiles* | | | |
| High estimate | 13,300 | 35,400 | 2.7 |
| Low estimate | 10,100 | 16,600 | 1.6 |
| Mean | 11,900 | 23,900 | 2.0 |
| *Artillery/mortars/multiple launch rocket systems* | | | |
| High estimate | 15,300 | 46,500 | 3.0 |
| Low estimate | 10,600 | 23,800 | 2.2 |
| Mean | 12,600 | 34,700 | 2.8 |
| *Combat aircraft* | | | |
| High estimate | 4,300 | 7,700 | 1.8 |
| Low estimate | 3,000 | 5,900 | 2.0 |
| Mean | 3,600 | 7,000 | 1.9 |
| *Division equivalents* | | | |
| High estimate | 107 | 192 | 1.8 |
| Low estimate | 88 | 101 | 1.1 |
| Mean | 96 | 136 | 1.4 |

Note: Estimates are for the entire European Theater (Atlantic to the Urals). The range of estimates is partially caused by differences in definition of each weapon category. High estimates often include weaponry that could be considered marginal to that category. Low estimates can be caused, in part, by an unusually narrow definition of the weapon category. The mean, and its ratio, is a product of the full range of sources, not simply the high and low estimates. Figures are rounded.

Sources: British Secretary of State for Defence, *Statement on the Defence Estimates 1988*, vol. 1 (London, 1988); Bundesminister der Verteidigung, *Streitkraftevergleich 1987 NATO-Warschauer Pakt* (Bonn, 1987); John Collins, *US/Soviet Military Balance: Statistical Trends 1980–1987* (Congressional Research Service Report 88-425S, April 15, 1988); Anthony Cordesman, *NATO Central Region Forces* (Jane's, 1988); Department of Defense, *Soviet Military Power 1988* (GPO, 1988); International Institute for Strategic Studies, *Military Balance 1987–1988* (IISS, 1987); testimony of Phillip A. Karber, *NATO Defense and the INF Treaty*, Hearings before the Senate Committee on Armed Services, 100 Cong. 2 sess. (GPO, 1988), part 1, p. 230; Phillip A. Karber, "In Defense of Forward Defense," *Armed Forces Journal International* (May 1984), p. 80; interview with Phillip A. Karber, *Armed Forces Journal International* (June 1987), p. 120; and NATO Information Service, *NATO and the Warsaw Pact: Force Comparisons* (NATO Information Service, 1984).

this matter is of limited significance, since even with a separate strategic force agreement, calculated aggression in Europe has no rational basis. From the perspective of rendering crisis interactions more manageable, however, the changes would be of great importance. No other circumstance worldwide could strain the two military establishments as seriously as a mutual alert in central Europe. If that situation were stabilized, all other potential crisis engagements would be notably eased.

This central principle for designing a more stable conventional balance in central Europe is consistent with the policy declarations of both alliances that each should be guaranteed an effective defense of its own territory but denied the assets necessary to conduct a successful offensive against the opposing alliance. Moreover, since a successful defense is generally believed to be easier to achieve than a successful offense, particularly if defensive positions are carefully prepared, simple equity produces the desired result. If NATO and WTO conventional forces had equal capability, then neither could attack with confidence, both could be assured of their territorial integrity, and the pressure to initiate operations under crisis circumstances would ease.

### *Measuring Equity*

The problem comes in the measurement and certification of equity. Very few of the recognized ingredients that contribute to conventional military power are equal between the two alliances *(see table 1)*. Nor are their geographic positions, their social conditions, or their economic and technical potential, all of which affect how much a given military capability contributes to overall security. No professional consensus has formed on methods for calculating conven-



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tional military capacity, nor is one likely to emerge soon. The assertion or denial of equity are matters of judgment about which there are many opinions.

For some, that is effectively the end of the story: the prospect for agreement is destined to be overwhelmed unless an acceptable basis for designing it is found. Advocates of this view usually cite the long unproductive negotiations on mutual and balanced force reductions in Europe as historical evidence for their expectation.

But again, that natural reaction seems too negative for the circumstances. It undervalues the power of a new security conception operating within the centrally planned Soviet system. It undervalues the influences operating on the more diffuse political system of the United States, most notably, the fiscal pressure on the defense budget. Despite the analytic disagreement that besets the topic, a political deal could be struck in which each side improved its security and relieved its longer-term investment burden at the cost of adjusting long-established planning assumptions and habits of unilateral decisionmaking on matters of mutual security. As has regularly happened in the course of military history, political actions might well precede a well-formulated rationale.

The outline of a potential agreement is not difficult to anticipate or even to calculate if appropriately modest claims are made about the calculation. The WTO is acknowledged to have more tanks, more artillery, and more organized ground combat units than NATO, and these disparities are at the core of NATO's traditional fears of a conventional invasion. NATO's comparative advantage is believed to lie in the quality of its forces — tactical aircraft, in particular, and more generally its ability to apply advanced sensing and information processing technologies to new weapons applications. That sets up incommensurate terms of exchange — current capability of WTO for future potential of NATO; ground force capability of WTO for tactical air capability of NATO. Such trades are the despair of analysts, political speech writers, and most officials facing an imminent election or other political accounting. They are, however, the delight of visionary leaders because they offer the potential for dramatic redefinition, and that certainly seems to be Gorbachev's attitude.

A deal designed to adjust the conventional balance in Europe — and to be dramatic in scope — would consist of four main elements. First, the size of fully mobilized conventional ground forces would be reduced, and the reduction would be substantially larger for the WTO than for NATO. The point of this measure is to reduce the disparity in aggregate firepower — from a ratio of 1.7:1 in the last officially published NATO estimate to one noticeably closer to unity. Second, some active units would be relocated away from the inter-German border, and this repositioning would also be disproportionately large for Soviet forces in East Germany. The purpose of this measure is to reduce the potential for a rapidly mobilized surprise attack; that potential could be reduced even further by expanding regulations on the movement and exercising of military units to make each alliance's operations more transparent. The number of active units remaining after these measures were implemented would be sufficient to maintain the coherence of the WTO military organization and the predominant Soviet role in it. Third, basic military units would be reconfigured and standardized to constrain their individual offensive capability.

*"The outline of a potential agreement is not difficult to anticipate or even to calculate if appropriately modest claims are made about the calculation."*

These three measures would require that the manning and equipment levels for some fundamental organization unit — most plausibly a regiment — be defined and regulated. The allowed number and required location of these units would be set for each side and would provide the basis for controlling and verifying particular items of equipment strongly associated with offensive missions. Large concentrations of artillery ammunition, for example, would not be allowed in forward positions. Because these stocks are massive and difficult to move, a successful offensive operation requires forward positioning, whereas a defensive strategy logically demands protective dispersal in depth. Similarly, large concentrations of bridging equipment would be prohibited in forward positions, and mine-clearing capabilities even more severely restrained.

Fourth, to balance the disproportionately large reductions and redeployments of WTO ground forces and to alleviate their fears of NATO technical superiority, there would be a corresponding definition, reduction, and redeployment of those tactical air units that are equipped and trained for ground attack missions deep into the opponent's territory. Restraints would also be placed on the rate at which the allowed units could be modernized. Both measures would disproportionately affect NATO's capability, particularly as it has been projected in recent defense plans.

### *Outer Boundaries of Agreement*

The political deal embodied in these four adjustments primarily affects the United States and the Soviet Union.



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Each would be formally accepting restraints that would probably be independently imposed anyway as the two countries manage their defense budgets. The Soviet Union knows it will be modernizing its conventional forces at a technical and economic disadvantage compared with the Western alliance; the logic for reducing the base force and the mission aspiration is therefore compelling. By focusing modernization efforts on a smaller force and a more realistic objective, the Soviets can produce security with the assets they have, whatever the NATO defense program might be. If the reductions can be used to encourage or to formalize technical restraint in NATO, so much the better from the Soviet viewpoint.

Conversely, the emerging pressures on the U.S. defense budget are likely to hold the development of very sophisticated deep interdiction capability well below what has been planned, giving the United States its own reasons for formalizing the arrangements. The incentives operating in the background on both sides make the deal feasible, even likely, despite the conceptual complexity and analytic difficulty of defining and justifying it.

If the deal is to be struck, however, this political logic must be incorporated in concrete measures. No matter how arbitrarily it is done, each side will ultimately have to determine the number of units to be reduced, redeployed, or reconfigured, and any explicit connection between the actions of the two sides will set practical terms of exchange. In the absence of a widely accepted calculus, anticipating how the necessary judgments about conventional forces will eventually be made is much harder than it is in the case of nuclear weapons. Nonetheless, some rough boundaries can be drawn within which a mutually acceptable outcome can be plausibly expected to fall.

One boundary concerns the total conventional force assets that each side could potentially assemble in central Europe. Current intelligence estimates indicate that the WTO might be able to mobilize 110 divisions after a 120-day preparation period. By that time NATO could have 49 divisions in position to resist. Because divisions in the two alliances are not the same size and because their standard level of equipment varies, most comparisons begin by determining the ratio of available firepower that the two forces would bring into battle. The comparison of current WTO-NATO firepower suggests that NATO forces committed to the defense of their forward positions and unwilling to retreat to gain tactical advantage might be damaged to the point of organizational disintegration within 5 days and be completely routed within 15. A net reduction of roughly 45 divisions would have to be extracted from the WTO forces to make the calculated assessment a stalemate with no loss of NATO territory. If NATO invested more in prepared defensive positions, the stalemate might occur if the WTO forces were reduced relative to NATO by 30 to 35 divisions.[3] Net reductions of these magnitudes can be taken as an outer bound for the amount necessary to deny the WTO offensive conventional capability in central Europe. Many would consider the balance acceptable with a lesser adjustment; there is no reasonable basis for demanding more.

A second boundary concerns the interaction of tactical air forces. The current inventories of NATO and WTO tactical aircraft have a different mix of purposes: NATO emphasizes both air superiority and ground attack and the WTO forces concentrate on air defense *(see table 2)*. If both forces committed themselves to an initial battle for air superiority and if NATO aircraft proved to be at least twice as effective as their WTO counterparts, NATO would establish dominant air superiority in three to four days and would emerge with roughly 2,000 fighter and attack aircraft at its disposal.

NATO would win more quickly and with more surviving aircraft if the WTO forces diverted their attention from the air superiority battle to pursue an interdiction campaign against the NATO nuclear storage sites. If stalemate in the air battle is to be the agreed outcome, then the NATO tactical air capability would have to be reduced by a net of about 1,000 aircraft, that is, by about 14 organized air wings.

Taken together, these two simple assessments suggest that a trade of up to 14 NATO tactical air wings for up to 30 to 45 WTO ground force divisions would achieve a balance that would allow both sides to be confident in projecting stalemate as the likely outcome of an engagement in central Europe. That implicit logic is directly bolstered by considering the performance assumptions for aircraft operating against ground force units.

The primary objective of NATO aircraft in such an engagement would be some 45 Soviet divisions that might be within two days march of the immediate battle line; the central question is whether the aircraft could prevent these divisions from arriving at the point of battle with enough capacity to fight effectively. A fully equipped Soviet division contains about 1,250 tracked vehicles — tanks, infantry fighting vehicles and armored personnel carriers, self-propelled artillery, and air defenses. To neutralize those divisions, the aircraft must reduce that inventory by about 50 percent in two days — the same level of attrition at which it was assumed that NATO forces would become ineffec-

***Table 2. Composition of Tactical Air Forces, European Central Front***

| | NATO | WTO |
|---|---|---|
| Fighter/attack aircraft | 2,800 | 1,250 |
| Interceptors | 800 | 2,000 |
| Air defense missiles | 1,350 | 2,200 |

Sources: Congressional Budget Office, *U.S. Ground Forces and the Conventional Balance in Europe* (GPO, 1988); and International Institute for Strategic Studies, *Military Balance 1987–1988* (IISS, 1987).


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tive. Based on peacetime experience, NATO aircraft could be expected to fly three sorties a day over two days while maintaining 80 percent of their expected performance capability and to each carry eight pods of scatterable munitions, the most effective weapon against tracked vehicles currently available. One thousand aircraft meeting these standards could neutralize all 45 Soviet reinforcing divisions in six sorties over two days if the planes suffered attrition of only 5 percent on each sortie and if 95 percent of their weapons reached their targets. The same 1,000 aircraft could neutralize 33 divisions — enough to stalemate the battle with prepared NATO defensive positions — if they sustained attrition of no more than 10 percent on each sortie and hit at least 80 percent of the targets. Though this performance assessment is idealized, it does fall within the theoretical capability of the aircraft and thus defines an outer boundary of potential agreement.

## *Implications*

The theoretical objective of sharply reduced, protectively configured strategic forces and the more loosely defined vision of a stabilized conventional balance in central Europe offer substantial scope to implement the doctrinal and diplomatic initiatives emerging from the Soviet Union. They also offer a major opportunity for the United States to improve security while relieving its long-term financial burdens. The force reductions outlined here would lower the U. S. defense budget by nearly $15 billion a year in fiscal 1989 dollars. Over the normal life cycle of the weapons systems in question — approximately 20 years — these additional savings would total more than $300 billion — the equivalent of an entire year's defense budget.

Whether these potential force reductions will actually be achieved in whole or in part is unknown, but the prospect alone is sufficient to alter the political conditions of international security and thereby to pose security interests for the United States that extend well beyond the standard conceptions of deterrence and containment formulated during the cold war.

In principle, the United States has compelling reason to initiate a policy adjustment comparable in spirit to the Soviet doctrinal developments but more specific in content and broader in scope. Even full implementation of the strategic force reductions and conventional force limitations outlined here would not establish a complete regime of cooperative security. Any diplomatically feasible reduction of strategic forces, for example, would necessarily continue restrictions on strategic defenses, but not necessarily extend these restrictions to protect surveillance and communication assets in space. Yet that latter protection is essential for preserving the coherence of the receptive command systems — the most important single element in controlling crisis interactions.

Similarly, this protected surveillance and communication capability must eventually be limited so as to distinguish the legitimate, essential functions of operational control and verification from the unacceptably intrusive observation required for preemptive targeting.

In general, as the technical determinants of military power shift from developments in nuclear explosives and rocket propulsion to developments in sensing and information processing, the most critical issues of regulation also shift. The problem of reliably preventing war is not just one of correcting force imbalances inherited from the past; even more it is one of avoiding those that have yet to develop.

In practice, however, the United States is poorly prepared to undertake such an initiative. The political process has divided security issues into those that are considered within the context of the federal budget and those that are discussed as part of specific treaty positions. Political debate has largely focused on immediate marginal increases or decreases in the defense budget, on individual weapons projects, on compliance with disputed treaty arrangements, and most recently on a vision of a perfect defense, inspired far more by domestic politics than by strategic or technical reality. The problems of operational interaction that appear to be motivating the Soviet doctrinal initiatives and that are at any rate emerging as leading security problems have been only dimly grasped in the U.S. political discussion, and the policy process within the government sharply separates this subject from the more familiar topics of the defense budget and arms control. Even the projected budget savings are likely to make little impression on American public opinion, and are therefore unlikely to move public decisionmakers.

This disparity between the requirements of security policy and the inherent limitations on its formulation imposed by the nature of the American political system is not easily remedied. The tension between substance and process is clearly a major drama in the evolution of democracy not likely to end soon. One can readily identify, nonetheless, a necessary and constructive first step. The United States will neither initiate its own changes in policy nor react appropriately to Soviet diplomacy until the need to do so is better developed and more widely understood. Nothing can substitute for a more extensive, more penetrating public discussion.

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1. The changes in Soviet doctrine and the force structure adjustments associated with those changes have been reviewed and interpreted in Michael K. MccGwire, *Military Objectives in Soviet Foreign Policy* (Brookings, 1987); and in Raymond L. Garthoff, "New Thinking in Soviet Military Doctrine," *Washington Quarterly* (Summer 1988), pp. 131–58. MccGwire and Garthoff vary in their judgments. But the accounts of both are generally compatible with the interpretation presented here, though neither is exactly the same.
2. A full explanation of these assessments may be found in Michael M. May, George F. Bing, and John D. Steinbruner, *Strategic Arms Reduction* (Brookings, 1988).
3. This comparison and the one for tactical aircraft were developed by William W. Kaufmann and are more fully presented in an occasional paper he wrote entitled "Quantitative Comparisons of Conventional Forces," Brookings, 1988.


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*William W. Kaufmann*

# *Restructuring Defense*

Defense budgets and the size and composition of the armed forces during the coming five fiscal years from 1990 through 1994 will present the next president with difficult choices. But while the decisions will be painful, the president can set a sensible and constructive course for the Pentagon during his first years in office. Opportunities as well as difficulties await him.

To underscore the complexity of the choices ahead, it is necessary only to enumerate the conflicting pressures that the president will have to take into account. On the one hand, he will be strongly advised that if he is to remove the trade and federal budget deficits and simultaneously meet the rising domestic demand for expanded federal services, he must at a minimum reduce defense expenditures. On the other hand, he will quickly discover that, while the allies of the United States could certainly contribute more than they are now doing to the collective security system, there will be no substitute for U.S. power and leadership in the foreseeable future. America may have become the first among equals, but like the British prime minister, it will remain first by a rather wide margin.

The president will also find out, if he does not already know, that major uncertainties remain about the future course of international relations. The grounds for optimism are considerable in light of the new leadership in the Soviet Union, domestic problems in the USSR and Eastern Europe that are much more intractable than those faced by the United States, progress in the resolution of several regional conflicts, ratification of the intermediate-range nuclear missile treaty, and the possibility of deep cuts in Soviet and U.S. strategic nuclear forces and a reduction in the conventional capabilities of the Warsaw Pact and NATO *(see p. 53).*

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But Soviet military power still remains impressive, and questions linger about the ability of Secretary General Mikhail Gorbachev to survive politically, implement his proposed reforms, and negotiate further arms control agreements unless he can demonstrate that he is successfully curbing the U.S. military buildup. Both he and the president will probably want to hang on to bargaining chips, however low their value on the negotiating table.

Finally, the president will face conflicting pressures from Congress and the Pentagon over the future size of defense budgets. While Congress was exceedingly generous to the Defense Department between 1980 and 1985, allowing a real increase in defense funding of more than 50 percent (the most rapid increase in U.S. peacetime history), it has since become more parsimonious. Not only has funding been reduced by more than 10 percent in real terms; many members of Congress seem bent on holding to that course in the 1990s.

Meanwhile, the military services, having been led to expect continued large increases in each year's defense budget, have continued both to modernize their forces with the current generation of weapons and to move rapidly to produce a next generation of still more sophisticated and costly armaments.

All told, during the coming decade, the weapons still to be bought in the current wave of modernization, combined with the programs now in the acquisition pipeline, could cost more than $900 billion. Furthermore, the newer weapons, if deployed, will probably drive up defense operating and support costs, thereby threatening to push future budgets well above the numbers considered by the Reagan administration and Congress.

## *The Range of Choice*

The problem created by these differing expectations is readily illustrated by three numbers. Caspar W. Weinberger, while secretary of defense, hoped to obtain annual real increases of 7 percent in budget authority to fund these ambitious investment plans, although he talked about only 3 percent annual real growth in his last five-year plan and would probably have fought for an annual real increase of 5 percent and a total of $1,945 billion (in current dol-


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lars) for the five-year period between 1990 and 1994. Such a plan would have permitted the Pentagon to finance more than half of the $900 billion worth of new investments.

Secretary Frank C. Carlucci, by contrast, has assumed that he could obtain real growth of no more than 2.2 percent a year, which would allow him a total of $1,715 billion for the same five-year period, or $230 billion less than the probable Weinberger projection. In the circumstances, something would have to give in the size or pace of the $900 billion investment program.

If the congressional track of the last four years were to be followed for the next five, the results would be even more severe. The resources available to the Pentagon would come to a total of $1,470 billion, or $475 billion less than Weinberger's estimate and $245 billion lower than Carlucci's. Both the secretary of defense and Congress would have to exercise the strictest discipline over the services and the budget to live within this total.

The rewards of such discipline would come in two forms. First, savings in expenditures would run to hundreds of billions of dollars over the five-year period, enough to contribute to a significant decline in the structural budget deficit (with the Social Security accounts excluded) or to pay for expanded domestic programs without requiring any real increase in the federal budget. Second, the Pentagon would gain a breathing spell in which to assimilate the current generation of weapons and plan more prudently than it recently has done.

*". . . there remains the issue of how cuts of the magnitude reflected in the congressional track can and should be made."*

## *Implementation*

While these rewards may seem enticing, at least to some, there remains the issue of how cuts of the magnitude reflected in the congressional track can and should be made. Resolution of the issue will be complicated by the conflicting pressures from the international environment. Under these conditions, it will not be simple or painless surgery to remove $475 billion from the Weinberger baseline plan, retain the military power and deployments necessary to underwrite U.S. commitments and leadership, keep pace with any advances the Soviet Union may make in its own capabilities, and at the same time leave the way open to deterrence and international stability by means of arms control and reductions. Critics might even wish to suggest that attainment of such ambitious and seemingly conflicting objectives would require, at a minimum, a squaring of the circle.

They could be right. The Defense Department, in addition to its 1.2 million members of the National Guard and Selected Reserve and more than 1 million civilian employees, maintains 2.1 million uniformed personnel on active duty, 25 percent of whom are stationed overseas. At least some members of Congress favor saving money not simply by reducing the size of the armed forces but by making a cut that would require the return and demobilization of many U.S. units now garrisoned in Germany, Japan, and Korea. Yet such a move would risk causing serious instability in three countries of great importance to U.S. security.

Along with the impulse to bring home the troops goes the desire to force the allies to share the costs of collective security more equitably, even though experts disagree about how to measure relative burdens or how ineq-

***Table 1. Estimated Five-Year Defense Plans, Fiscal 1990–94***
*(Budget authority in billions of dollars)*

| Category | Weinberger Plan | Nominal Freeze | Difference | Host Nation Offsets | Net Difference |
|---|---|---|---|---|---|
| Military personnel | $480.4 | $431.6 | $ 48.8 | $ — | $ 48.8 |
| Operation, maintenance | 544.6 | 474.8 | 69.8 | 16.5 | 53.3 |
| Procurement | 585.4 | 348.8 | 236.6 | — | 236.6 |
| RDT&E | 272.4 | 177.6 | 94.8 | — | 94.8 |
| Military construction | 38.9 | 22.5 | 16.4 | 9.3 | 7.1 |
| Family housing | 19.4 | 14.0 | 5.4 | 4.2 | 1.2 |
| Other | 3.9 | 0.7 | 3.2 | — | 3.2 |
| **Total** | **$1,945.0** | **$1,470.0** | **$475.0** | **$ 30.0** | **$445.0** |

Source: Author's estimates. For a full explanation, see the Kaufmann chapter on the defense budget in John D. Steinbruner, ed., *Restructuring American Foreign Policy* (Brookings, 1988).


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| Service | Programs in the Pipeline* | Amount Funded by Nominal Freeze | Remainder |
|---|---|---|---|
| Army | $ 92.4 | $ 59.9 | $ 32.5 |
| Navy, Marines | 318.7 | 166.1 | 152.6 |
| Air Force | 446.5 | 131.0 | 315.5 |
| Defense-wide | 50.0 | 16.0 | 34.0 |
| **Total** | **$907.6** | **$373.0** | **$534.6** |

*These numbers are estimates of what major investment programs will cost if all of them go into full production, with one exception. No allowance is made for the deployment of any anti-ballistic missile defense. The total for the programs in the pipeline would increase to more than $1.4 trillion if all investment were included. Of the $907.6 billion total shown here, more than 23 percent is for nuclear forces.

***Table 2. Expected Major Investment by Service, Fiscal 1990–99***
*(Budget authority in billions of dollars)*

Source: Author's estimates. For a full explanation, see the Kaufmann chapter in John D. Steinbruner, ed., *Restructuring American Foreign Policy* (Brookings, 1988).

uitable the current sharing of the burdens really is. That difficulty aside, it seems not too much — and not unprecedented — to ask Germany and Japan, in particular, to pay the full costs of playing hosts to U.S. forces on their soil — costs that could run to $30 billion over five years.

To go beyond such a request is to risk not only political and military instability, but also a decision to replace the American presence with nuclear rather than conventional capabilities of their own. Neither our other friends nor the Soviet Union would gain much comfort from such a development in Germany and Japan.

A less disruptive way of reducing outlays would be to rescind some of the balances of prior-year budget authority that the Defense Department carries, an estimated $271 billion by the end of fiscal 1989. Of that total, $231 billion will have been obligated, largely to contracts for weapons research and procurement; the remaining $40 billion will not yet have been committed.

In principle, and at a penalty, many of the contracts could be cancelled, the unobligated authority recovered, and future outlays brought under stricter control. In practice, the Gramm-Rudman-Hollings law denies Congress the right to rescind obligated authority, and any effort to retrieve large amounts of unobligated authority is likely to cause contracts to be let in an inefficient fashion.

In any event, Congress traditionally has balked at cancelling contracts for big-ticket items, just as it remains reluctant to reduce the accounts for major investments in current budgets. Its preference is for cheese-paring — for slicing what seem like relatively small amounts from accounts that lack either visibility or large and powerful constituencies, but which in the aggregate can amount to many billions of dollars. Thus the defense structure may appear to stand rock-solid, even though much of its essential support may have been eaten away.

For fiscal 1989, Congress allocated $300 billion of budget authority for national defense and estimated outlays at $294 billion. The likely consequence of congressional preferences is that any effort to freeze budget authority or spending for national defense at 1989 levels will produce at least as skewed an allocation of resources among defense functions as now exists and an abysmal failure to reach the objectives that seem appropriate for the near-term future.

*"Thus the defense structure may appear to stand rock-solid, even though much of its essential support may have been eaten away."*

Nonetheless, a determined president combined with a loyal secretary of defense can still produce a capability, even within severe budgetary constraints, that will provide deterrence and international stability through the difficult period of transition that lies immediately ahead.

## *A Program*

What cuts would have to be made to maintain about the current force structure and overseas deployments, high readiness and continued progress toward wartime sustainability goals, improved intercontinental mobility, and continued modernization along with major hedges against a breakdown in the rapprochement with the Soviet Union? One set of possibilities is shown in table 1.

As can be seen, the table contains three major assumptions. The first is that a carefully designed Weinberger defense plan for fiscal 1990 to 1994 would have come to a total of $1,945 billion and would have been allocated among appropriation categories as indicated. The second is that the reduction must be made from the Weinberger baseline for the simple reason that Secretary Carlucci has not yet



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specified his overall budget plan for the same period or how he would cut the Weinberger baseline by $230 billion to reach his goal. The third is that allies (most prominently Germany and Japan) would agree to pay for the full costs of the facilities and local civilian personnel associated with the stationing of U.S. forces in their countries.

The net reductions fall quite heavily on military personnel and operation and maintenance, which are cut by more than $100 billion. Such a cut appears to contradict the assertion that current force structure, readiness, and overseas deployments would be maintained under what amounts to a nominal freeze in budget authority (that is to say, a freeze at 1989 levels that does not take into account the effects of inflation).

However, it should be emphasized that the net reductions occur, not because of any reduction in components necessary to force effectiveness, but because the force is somewhat smaller and less costly to operate than the capabilities sought in the Weinberger plan.

The Army remains stable in size and composition (with 18 active and 10 reserve divisions). But the Navy falls back to 12 deployable carrier battle groups, a Marine Corps division's worth of amphibious lift, 97 nuclear-powered attack submarines, and a total of 570 ships. The Air Force, for its part, is denied an expansion of its strategic nuclear capabilities, its tactical air wings are held at current levels, and its airlift is only slightly expanded.

As the table shows, the biggest blow is struck at the two main investment accounts: procurement and RDT&E (research, development, test, and evaluation). These reductions will also generate the greatest resistance from the services and Congress, since they appear at first glance to mortgage the future for the present and threaten to have an adverse effect on local economies. What happens to each major component is summarized in table 2, and the results do indeed look devastating. However, relatively few programs are actually cancelled.

What happens, quite intentionally, is that modernization of the forces continues with a further acquisition of the current generation of weapons platforms and missiles (or other ordnance). But the next generation of platforms is held in RDT&E. Emphasis is placed on building prototypes of and testing systems such as the Army's experimental light helicopter family and its forward area air defenses, the Navy's Seawolf nuclear attack submarine and its advanced tactical aircraft, and the Air Force's B-2 (Stealth) bomber, small ICBM (Midgetman), and advanced tactical fighter. The strategic defense initiative (SDI or Star Wars) reverts to a more modest program of research and development. The consequence is a saving of more than $330 billion, or nearly 75 percent of the total reduction required to reach a nominal freeze.

*"The time has obviously come to restore discipline to decisionmaking and its implementation in the Defense Department. . . ."*

## *Effect of a Freeze*

The results of the nominal freeze undoubtedly sound and are brutal, given the expectations of the defense industry and the Pentagon. However, the program still provides a good deal of work for industry on top of the backlog of orders that already exists. The freeze slows the rollover of the weapons inventory to the traditional 20-year pace (a policy that has served us well in the past), while it provides sufficient funds to upgrade the performance of the current generation of weapons.

Most important of all, it puts a halt to concurrency — a policy that rushes systems such as the B-1B and the B-2 into production before they have undergone full testing, costing, and evaluation. In its place, the strategy substitutes "fly before buy," a policy that former Deputy Secretary of Defense David Packard attempted to institute in the early 1970s. Considering the technical demands being placed on the defense industry — largely owing to exaggerations of the threat it must prepare for and an undue preoccupation with the time needed to develop, produce, and deploy new weapons — the introduction of such a policy is long overdue, quite apart from concerns about trade and budget deficits.

A legitimate issue about the changes imposed by a nominal freeze is how well the nuclear and conventional forces would perform relative to the capabilities that could be acquired under the estimated Weinberger and Carlucci plans. Admittedly, the techniques for resolving this difficult issue are quite primitive and, for the most part, leave out a host of factors that could prove crucial in determining the outcome of a nuclear exchange, a conventional battle or campaign, and hence the extent of deterrence and international stability.

Granted these difficulties, analyses that concentrate on force structure and its performance, assuming that most other factors favor neither one belligerent nor the other, suggest that a nominal freeze in budget authority, sensibly allocated, would produce outcomes at least as favorable as would the less efficiently allocated resources of the Weinberger or Carlucci plans. In the latter two cases, too many funds are devoted to redundant strategic nuclear capabilities, expensive naval forces in excess of U.S. needs, and new weapons systems in general that are unlikely to increase combat performance commensurately with increases in cost or changes in potential threats.

The time has obviously come to restore discipline to decisionmaking and its implementation in the Defense Department and to change the wasteful regime under which the department has operated for so long. The U.S. military establishment has gained more fat than muscle during the last eight years. It is important to provide that expensive but indispensable body with a leaner and more balanced diet. Others will undoubtedly decide whether it needs a new head.



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*William B. Quandt*

# *Middle East Challenges*

The man inaugurated as president on January 20, 1989, will not have long to think about the Middle East before pressures mount for decisions. The new leader of Israel will be eager to be invited to Washington, as will the president of Egypt. Requests for arms and economic aid will be used to test the intentions of the new administration. Votes at the United Nations will have to be cast. Secret emissaries from Iran, the Palestine Liberation Organization (PLO), Libya, and other "off-limits" parties will be hinting that great breakthroughs in relations lie around the corner. How to make sense of it all?

The first step for a new president is to realize that there is no simple blueprint. Forget all slogans when dealing with the Middle East. Mistakes are usually made by trying to fit Middle East issues into preconceived frameworks. The problems cannot be dealt with exclusively through a cold-war approach. A strong dose of realism and pragmatism will be more helpful than grand designs.

Fortunately, the president will be able to consider Middle East policy issues without the specter of "oil blackmail," an imminent threat of war, or aggressive Soviet moves in the region. Nonetheless, real problems exist, and the challenge will be to address them before they become acute crises. The following issues are some that will need early consideration.

## *The 'Peace Process'*

A continuation of the Israeli-Palestinian confrontation and an impasse in the peace process run the risk of eventual war between Israel and some of its Arab neighbors; they place pressure on the Egyptian-Israeli peace; and they breed extremism in the region. Thus, the new president will want to explore all possible openings toward peace. There is no magic formula to be imposed, but there are some positive elements to work with.

Whatever Israeli government is formed will be on record as being willing to negotiate with its Arab adversaries, but neither major bloc will deal directly with the PLO. At the same time, no Palestinians will step forward to negotiate authoritatively with Israel without the PLO's blessing. How to square this circle?

The answer, I believe, is to try to persuade the PLO to change its political program. Some Israelis would still refuse to deal with a reformed PLO, but many would not. The key will be to get a clear commitment from the PLO to accept UN Security Council Resolutions 242 and 338; to recognize the right of all states in the region, including Israel, to live in peace within secure and recognized borders; and to condemn terrorism in all its forms.

The PLO will not make such a move without some inducement. For years, American policy has been frozen on this issue. Now the time has come to make it worth the PLO's while to revise its political program in the direction of peace. To do so, a new administration should be willing to respond positively if the PLO meets long-standing American conditions. The administration should state clearly that the United States is prepared to make a sustained effort to get the negotiating process started; that Palestinians should be represented in those negotiations by spokesmen of their own choosing; and that the principles governing negotiations are those embodied in U.N. Resolution 242, including the "territories for peace" formulation, as well as respect for the legitimate rights of all parties, including the right of the Palestinians to pursue self-determination through negotiations.

This formulation would not guarantee the Palestinians a specific outcome from negotiations — such as an independent state — but it does promise them a seat at the negotiating table where they can raise any issue, including statehood, just as the Israelis can be expected to raise questions of concern to them. All the United States can say at the outset is that certain principles will enjoy our support. The parties to the negotiations will fashion the details of the eventual peace settlement. If they can live with it, so can we.

Israelis and their friends in this country will be nervous as the United States tries to bring the Palestinians

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into the peace process. One way of trying to allay Israeli concerns would be to demonstrate that the United States does understand that security issues must be addressed at each stage of the peace process. If Israel is to relinquish control over land — as it must if there is to be peace — it has to feel that enforceable security arrangements will be in place and that the overall military balance will not shift to Israel's disadvantage.

One step the United States could take would be to hold out, for the first time, the prospect of a full-fledged security treaty as part of an overall settlement. Some will say that Israel already has de facto status as an ally. Others will scoff at the reliability of a formal security commitment from the United States. Still, many in Israel will find the offer both credible and attractive. Let the Israeli public debate the merits of relinquishing the occupied territories in return for peace with the Arabs and a treaty with the United States. The results might surprise us.

## *Egypt*

The United States now provides over $2 billion a year to Egypt in economic and military assistance. As essential as this aid may be, it is not producing the results that either side had hoped for. Development is slow. And now debt repayment, running at an annual rate of nearly $800 million, is becoming a major political issue between Cairo and Washington.

Like many other countries in the Third World that have had state-controlled economies, Egypt is finding the process of economic liberalization to be extremely painful. As subsidies are removed from food and energy prices, the economically disadvantaged are being squeezed. The presumed benefits of liberalization lie in the future. The pain is now.

The United States needs a policy that can relieve the debt burden on countries like Egypt, while at the same time keeping incentives in place to carry through the reforms that are essential for the long term. Two possibilities stand out. First, the United States could provide a larger share of economic assistance to Egypt in the form of cash grants, as it does to Israel. Egypt would be relieved of the high-cost "buy American" component of the current aid program, and it could use some of the new aid to pay off past debt. The difficulty, of course, is that a large infusion of dollars into the Egyptian economy could exacerbate some problems, including inflation and corruption.

The second way to help Egypt is to work with other creditors to reschedule and reduce the $40 billion-plus in outstanding debt. Debt rescheduling now depends upon agreement between Egypt and the International Monetary Fund (IMF) on economic reforms. Those talks may remain stalemated for some time. As elsewhere, IMF advice is not readily taken when the political consequences are seen to be dangerous. New thinking is needed on the problem of third-world debt generally, and in the case of Egypt in particular.

## *U.S.-Soviet Dialogue*

The next president will be the first in a long time who may be able to talk with the Soviets constructively about Middle East issues. General Secretary Mikhail S. Gorbachev has repeatedly said to Arab leaders that they cannot count on Soviet support if they initiate a military confrontation with Israel. He has stated openly that normalization of Soviet-Israeli relations is in the offing. The pattern of arms supplies to Syria seems consistent with the idea that Moscow is holding back, at least to some extent. The two superpowers have begun talks on the dangers of introducing more surface-to-surface missiles and chemical and biological weapons into the Middle East. And the Soviets appear to be serious in their commitment to withdraw from Afghanistan.

If this somewhat hopeful picture is confirmed by events, then we may be able to conclude that the Soviets are engaged in a fundamental reassessment of the Middle East. It might go like this. The Middle East has not been a promising arena for building socialism. (Only South Yemen has an avowedly Marxist-Leninist regime.) Conflicts in the region — Arab-Israeli wars and Afghanistan — have the capacity to damage U.S.-Soviet relations. They are too risky, and offer too small a payoff, to Soviet leaders whose priorities are focused on internal reform. Given the intimate nature of the U.S.-Israeli relationship, any move by Moscow to align itself with anti-Israeli actions could adversely affect arms control negotiations and other bilateral issues between the superpowers.

This reassessment would not mean that the Soviets will simply pack their bags and leave. They will remain committed, especially to Syria, but will compete through diplomatic and political means more than with arms transfers and aggressive policies. This scenario is a possibility, at least, that the new president should explore as part of the overall U.S.-Soviet dialogue.

## *Some Personal Advice*

My final words of advice to a new president are to take some time to think. Do not act on instinct. Get acquainted with the issues and the players. They are complex, but not impossible to understand or hopelessly irrational. Then move with an eye toward long-term American interests, which can be best served by a stable and peaceful Middle East.

It will not be easy, but you probably have a chance to accomplish something significant in the Middle East. Also, remember not to say too much in public at the outset. No one knows quite where you stand. Keep it that way for a while. Do not appoint a special emissary. Use your secretary of state instead.

Once you know what your priorities are, your actions will speak eloquently. You should then think of how to articulate your policies in ways that strengthen moderate forces in the region, win support at home, and give hope to those who want peace and look to the United States for leadership. Finally, remember that if you do not make your own Middle East policy, it will be made for you — by Congress, by lobbies, and by events beyond your control.



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# Making It Happen

## Thoughts for a New President on Process, People, and the Press

Stephen Hess

There is no shortage of proposed policies and programs from which a new president can choose. Their excellence alone will not make them happen. Making them happen depends on the skill of the assistants and advisers the president appoints, the paths he picks, the way he relates to the press, among other factors. Happening is the focus of these thoughts, which are intended for a first-year president who wants to be reelected.

(I think it quite probable that a president who decides — but does not announce — that he is not going to seek reelection would conduct himself differently. Since second terms are always downhill anyway, this notion is worth testing sometime.)

### Getting a Fast Start

As Richard Nixon was about to take office in 1969, his speechwriter Raymond Price sent him a memo. "For a third of a century, the fashionable critics have been measuring progress according to the standards established by [Franklin] Roosevelt in his first 100 days," Price wrote. "If we're going to change the pattern of government, we've got to change the standards of measurement."

Doing away with this accent on the hundred days — what Price called the "frenzies of activity for activity's sake" — is the consummate good government proposal. A new president deserves time to take stock of the executive branch, choose personnel, and design a legislative program. Price's advice is not wrong, but no president can afford to follow it. Presidents no longer have the luxury of settling in.

The logic of the hundred days strategy is that presidents can get things from Congress and others that will not be forthcoming later. The good will and fair play accorded a newly minted presidential administration do not last long. A president must grab for the brass ring when it comes around. But the overriding reason for a fast start is not directly related to a president's so-called honeymoon period. Rather, the attention of the public and the mindset of the media are such that a president initially is noticed in a way that is unlikely to happen again. What a president does in his first few months in office is apt to cast his image in a mold that is extraordinarily difficult to recast. The public perceptions of the Carter and Reagan presidencies became firmly fixed in the first year even though historians are going to prove that those early impressions were not accurate portrayals of those presidents' time in office.

A president-elect might once have been advised to "take your lumps early." Such advice is now counterproductive and the new adage becomes "have a decisive victory, then

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*"Presidents do have accomplishments after the first year, but those achievements may be cold comfort when they run for reelection. In electoral terms, then, getting off to a fast start is imperative."*

take your lumps." Indeed, a new president who comes to office without a complete program should promptly develop a limited agenda designed to produce at least one early decisive victory. Presidents do have accomplishments after the first year, but those achievements may be cold comfort when they run for reelection. In electoral terms, then, getting off to a fast start is imperative.

The fast-start strategy calls into question the value of a "multiple advocacy" staff system in which the clash of competing ideas promises to produce a well-tested policy. The more opinions, conflicting or otherwise, a president is given, the longer he will take to make a decision. Richard Nixon did not announce his domestic program until August of his first year. The delay was not his choice — for those involved in the process, Nixon's impatience was a clear and present danger. Nor did his advisers lack energy and talents. The problem was the president's system of multiple advocacy. The tug-of-war between Daniel P. Moynihan and Arthur Burns, resident scholars on the White House staff, ultimately mediated by John Ehrlichman and George Shultz, was not resolved for more than six months. Although adequate staffing of alternative proposals helps avoid mistakes, a president cannot wait for the perfect proposal any more than a surfer can wait for the perfect wave.

Getting a fast start is easier if the president-elect uses the 10 weeks between election and inauguration well. Planning for the transition even before election day is sensible but, understandably, has little priority; candidates and their inner circles must dedicate themselves to the job at hand, winning the election.

Recent transition operations have been larger and more elaborate than in the past, a trend that has been encouraged in 1988 by increased federal subsidies. Transition organizations are ad hoc arrangements. Yet as the apparatus becomes bigger and bigger, there are some who see it as an end in itself rather than as a means to establishing a presidential administration. Of Reagan's 1980 transition, Carl M. Brauer comments, "What residents and observers of Washington often saw was the blizzard of task forces, committees and teams that [Edwin] Meese devised in part to reward, flatter, and occupy the conservative faithful."

Transition organizations are always plagued with conflicts between "the politicians" and "the experts," those who are there because they helped the candidate get elected and those who are there because of special knowledge of how government works. Transition organizations are under added stress because many of the workers in them hope to find jobs in the new administration. Much time is spent bickering and gossiping, with the production of misinformation becoming so substantial as to eat into the energy of the small circle of those who really are advising the president-elect. As Meese was fond of saying in 1980, "Those who know aren't talking and those who are talking don't know."

Since the basic work of this period is the choosing of fewer than 100 executives for the agencies and White House, a task that only the incoming president and his most intimate advisers can accomplish, a leaner, streamlined transition operation has much to recommend it.

## *Avoiding Contrariness*

Every incoming president vows that he will not make the same errors as the outgoing president. That the outgoing executive has made mistakes is a given. That new presidents judge they have a mandate to be different is also a given. This drive to be different is most obvious if the new administration is of a different political party than the old administration, especially if an incumbent president has been defeated. But the urge to start afresh is present even when the new president is the old vice president. The principle of contrariness is very strong.

Newly installed President John Kennedy disbanded recently departed President Dwight Eisenhower's National Security Council machinery and consequently was left without a proper advisory body in the White House during the Bay of Pigs crisis. Jimmy Carter's antipathy to having a chief of staff was partly a reaction to the way Richard Nixon ran his White House. The adage to be recalled is "don't fight the last war."

For the incoming president, the danger of contrariness is that he will respond to Reagan's unengaged presidency by returning to Carterism. The president-elect must guard against abolishing things Reaganesque simply because of their provenance. One possible change that the principle of contrariness might suggest is the relationship between



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president and cabinet. The cabinet as an organizing principle around which to form an administration has gone out of style. Cabinet government was done in, in part, by the inappropriate multiplication of cabinet departments. Presidents, and Congresses too, have been unable to resist the entreaties of special pleaders. Carter gave seats at the table to Education and Energy. Then, despite promises to abolish the two new departments, Reagan decided to keep them and to recommend the Veterans Administration for cabinet status. Individuals, too, were added on the basis of special claims, notably Office of Management and Budget Director Bert Lance (under Carter) and CIA Director William Casey (under Reagan). The full cabinet became a crowd, not an advisory body. Personnel problems also occurred: Carter lost respect for some members of his own cabinet; Reagan put in his cabinet some persons who lost the respect of important constituencies.

The point is a president must figure out what a cabinet can and ought to do, what a staff can and ought to do. Although it was hardly noticed by public and press, Reagan created what his aide Martin Anderson calls "a fairly elegant solution to the problem of how to effectively use cabinet members in the development of national policy." Reagan's cabinet council system consisted of six subgroups of cabinet members arrayed by topic, such as natural resources and the environment, commerce and trade, and so forth. In his book *Revolution,* Anderson reports that by the first week in December 1981 there had been 112 cabinet council meetings, roughly one-fifth of them chaired by the president. Anderson notes that on each of these occasions six or so cabinet officers and White House staff members talked before and after each meeting. "These short impromptu discussions among and between the president's policy advisers," he writes, "were probably as important to the advancement and development of his policy as the meetings themselves. Valuable pieces of information were exchanged, disagreements worked out privately, and Reagan's advisers got to know each other personally, intimately. It created, for a while, an unusual degree of harmony between two normally antagonistic groups, the White House staff and the cabinet."

Anderson's fascinating account of life within the Reagan White House may claim too much for what can be developed through cabinet councils. The system works best on issues least important to a president — issues like natural gas deregulation, telecommunications, federal credit policy, migrant workers, all mentioned by Anderson as having been studied. While less important than war-or-peace, boom-or-bust, such presidential policies are still very important and may escape presidential attention unless some high-level mechanism such as a cabinet council is in place to force decisions. The White House should keep in touch with the cabinet for other reasons too — ego-massaging, cheerleading, good communications, early warning. But if only as a strategy for secondary policy development, Reagan's cabinet council design deserves respectful consideration.

The major test of the principle of contrariness in 1989 could be how the new president responds to "Irangate." If hard cases make bad law, as the lawyers say, so too do the sort of presidential actions that are given the "gate" suffix. Fortunately, in this case a presidential special review board and two congressional committees have wisely reminded us that some "gates" are not susceptible to quick-fix solutions. When President Reagan chose to sell arms to Iran, he was disregarding the advice of his secretaries of state and defense. The fault was in the president's judgment, not his advisory system. The report of the congressional investigating committees rightly concluded that "Congress cannot legislate good judgment." Questions of legality aside, when Oliver North arranged to divert funds from the arms sale to the Nicaraguan contras, he violated rules of behavior that for four decades have restricted NSC staffs to an advisory, not an operational, role.

An irony of the Iran-contra affair is that Reagan initially wanted to downgrade the NSC. In his book, *Speaking Out,* White House press spokesman Larry Speakes said it looked as if "the President and his top aides . . . had such low regard for the position of NSC director that they paid little attention to those who held the post." If so, the president paid dearly for his indifference. (Ultimately, of course, Frank Carlucci, a veteran public administrator, was brought in to clean up the mess.)

The special review board, known as the Tower commission, offers some sensible advice on the role of NSC directors: they should have direct access to the president and not have to report through some other White House

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official; they should not try to compete with the secretary of state and the secretary of defense as the "articulator of public policy"; and they should focus on "advice and management, not implementation and execution." (The commission also gives a sound explanation of why the head of the NSC should not have to be confirmed by the Senate.)

## *Picking the PIP*

On every president's staff, deliberately or inadvertently, initially or eventually, there is a first among equals, a *primus inter pares*. The PIP will have different titles in different administrations — the assistant to the president, chief of staff, special counsel. And while the PIP is often thought of as a single person — a Sherman Adams under Eisenhower, for example — Richard Neustadt reminds us that there is almost always more than one "senior among seniors" in the White House. PIP is the acronym of a collective noun. Baker-Meese-Deaver of Ronald Reagan's first term is a PIP.

The hierarchical model of a White House staff — usually drawn as a pyramid — is associated with Republicans Eisenhower and Nixon; the so-called spokes-in-a-wheel model, with the president at the epicenter, is associated with Democrats Roosevelt, Kennedy, and Johnson. Whatever genetic material makes one a Republican or a Democrat may well predispose a president to an organizational tendency. (Some organization theories are based on less evidence.) In fact, the more that is known about presidencies, the less the actual operation of the White House corresponds to boxes on a chart. Reagan's first-term White House, for instance, has been described as "a hybrid of the spokes-in-a-wheel and chief-of-staff designs." And even Eisenhower's White House, which was considered the purest of pyramids, was considerably more spokish (or wheelish) than the textbook presentation.

The schema of political scientists, although pedagogically useful, do not truly reflect the world within the White House, where presidents tend to end up with a design that most resembles an isosceles trapezoid — a pyramid with its top chopped off. In other words, recent presidents, including Ford and Carter, ultimately relied on a semi-hierarchical staff system, a chain of command that permitted a small group of top aides direct access to the Oval Office.

The skills of a campaign manager are not what the new president most needs when picking the PIP, though not all campaign managers lack PIP skills. Such skills are more likely to be found in the campaigns of "insider" candidates. Hamilton Jordan, the architect of Carter's 1976 victory, claimed to be uninterested in the ways of Washington. Had Jordan been more interested, Carter might have had an easier time of it. Although on-the-job training is possible, it is hardly the most efficient way to get off to a fast start, especially since there is no shortage of those possessing the necessary skills. Reagan, another outsider, chose James Baker, a former official in the Ford administration, as his chief of staff, which then gave him the luxury of adding two California associates without Washington experience to complete a three-person PIP.

The PIP should be deeply schooled in and sensitive to the arcane ways of Washington. The PIP is the president's fail-safe mechanism, the last redoubt between him and a misstep. If the PIP does not know the location of all the traps that are set for a president in the capital, the president is likely to fall into one. This part of the job description is the pit of the PIP; the rest, public relations skills or policy development skills, can be brought into the White House in subordinate positions, if necessary. PIPs who interpreted their responsibilities to the president largely in managerial terms — H. R. Haldeman and Donald Regan — served their presidents least well, but that need not have been their history had they also had the political antennae that the job requires. The PIP as manager, however, makes enemies fast and thus should be expected to have a shortened lifespan in the job.

Changing PIPs in midstream — as Reagan did in 1985, for example — is a perfectly sound strategy. Those at the top burn out; one can be a president's lightning rod for only so long. Replacing Baker-Meese-Deaver with Treasury Secretary Regan may have been considered inside the White House as the logical reflection of the differing needs of a first- and second-term presidency. But that the president should have swapped such a successful PIP for one that proved so unsuccessful may also suggest that the qualities needed in the job had been incorrectly assessed.

What background offers the greatest possibility for success? Former Senator Howard Baker, whose entire Washington career had been in Congress, is unique in that he was pressed into service to add his own prestige to a battered presidency. Other PIPs served in Congress for briefer periods (Sherman Adams and Donald Rumsfeld) or had been congressional staffers (Theodore Sorensen, Walter Jenkins, Dick Cheney). An understanding of the legislature is helpful, but ignorance of Congress is fatal.

Chief executives must be sorely tempted to turn their most trusted political friends into their PIP. After all, presidents are surrounded by strangers, supplicants, and sycophants. Yet presidential friends who have become PIPs often have been the least effective. (Presidents need a friend, a role sometimes played by the First Spouse.)

While organizational design — or lack thereof — helps or hinders a president in reaching his goals, the decisive element in forming a successful administration is personnel selection. People. When the history of PIPs is written, it will illustrate the variety of ways that they have failed, personally and professionally. As Bruce Buchanan has put it, "Great chiefs of staff . . . may be no less difficult to locate than great presidents . . . ."

## *Staffing the White House*

A long-standing tenet of public administration holds that the president's immediate staff should be small. "A large staff of personal assistants will reduce the President's ability to control those persons who speak directly in his


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name," according to a 1980 report of the National Academy of Public Administration. Bradley Patterson made these estimates in 1988 of the number of people who are considered White House staffers: the White House office (including the Office of Policy Development), 568; the National Security Council staff, 190; the Office of the Vice President, 98; and the 45 percent of the Office of Administration that directly supports the White House, 91; for a total of 947.

Cuts in White House personnel, perhaps around 10 percent, could be negotiated with Congress on a reciprocal basis, since Congress is also under attack for the growth in the size of its staff. Such negotiations, Samuel Popkin observes, "might approach the complexity of discussions on arms limitations with Russia." But the issue is really one of functions, not numbers.

The White House unit whose function is most often questioned is the Office of Public Liaison. Set up by Charles Colson in the Nixon administration, it has through the years amassed a body of presidential assistants to look after the concerns of business, labor, women, blacks, Hispanics, Jews, youth, the aged, Native Americans, consumers, ethnic groups, and farmers. Robert F. Bonitati, who served in the office in the Reagan White House, stated its problems succinctly: "1) It raises the visibility of many issues that do not deserve such attention; 2) it brings issues into the White House that should be settled elsewhere in the government; 3) it enhances the importance of the 'interest groups' being represented; and 4) it raises some troublesome questions about 'interest groups' advocates participating in policy-making decisions impacting their constituencies."

*"Clearly the White House organization and its size will not remain static. They respond to political, technological, and institutional changes. Yet the new president would do well to start from the premise that small is still beautiful."*

While these White House aides represent the president to groups whose support he needs to govern and to get reelected, these aides are more accurately described as presidential employees who represent certain interests within the White House. President Carter's experience with his counselor on aging, Nelson Cruikshank, makes this point. Joseph Califano, who was then secretary of health, education and welfare, recounted the incident in his book, *Governing America:*

> Then, on January 24th [1979], Carter called. "Cruikshank is threatening to resign as my Counselor on Aging unless he can speak out publicly against the Social Security reduction proposals."
>
> "I don't see how you can run your government and let a presidential aide attack the President's proposals," I responded.
>
> "Hamilton [Jordan] is concerned that if Cruikshank quits, he will organize all the senior citizens groups against us," Carter said.
>
> "Can't he just stay on and keep quiet? Just not support the proposals actively?" I suggested, seeking to salvage the situation.
>
> "I tried that. But Cruikshank wants to oppose them publicly," Carter said.

Cruikshank stayed on, and in Califano's words, "delivered a stinging attack on the Social Security proposals before the [House] Committee on Aging." Special group advocacy within the White House increased under Reagan. It is time to reverse this trend and abolish the office.

Most Carter and Reagan aides who have commented on White House management generally suggest trimming its size. "As with the ships of the Spanish Armada, size is a crippling handicap, not a source of strength," Ben W. Heineman, Jr., and Curtis A. Hessler wrote in *Memorandum for the President.* Mitchell E. Daniels, Jr., who was assistant to the president for political affairs from 1985 to 1987, proposes abolishing the White House political office, preferring to connect the president to his party by putting the national chairman in the cabinet. More appropriate, in my opinion, would be to give the party chairman the additional title of assistant to the president and transfer the duties of the political office to the national committee, which would breathe new life into the party system and leverage the president's political outreach all at the same time.

There is one area, however, where presidential assistants argue that White House growth is justified. "[The Office of] Legislative Affairs can no longer just deal with Congressional leadership on a particular item," says Franklin L. Lavin of the Reagan staff. "Important votes, such as the Bork nomination [to the Supreme Court] or contra aid, involve 'hand-to-hand combat' — working with any number of Members to get their votes. This means Legislative Affairs must be a larger organization." A White House office could be designed to parallel the congressional whip system, composed of presidential assistants each responsible for the care and feeding of legislators from a certain geographic area. Unfortunately, the probable result



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is that legislators' demands on the president would increase faster than the president could add lobbyists.

Furthermore, relief for the president may already be on the way. While the emergence of the individualistic Congress in the 1960s and 1970s was dramatic, less noticed has been a recent countertrend on Capitol Hill that Roger H. Davidson has labeled "the new centralization." He notes, for example, a "renaissance" in party-line voting. What has caused this quiet change? Davidson writes that "looming deficits and the need to reach painful decisions about priorities [have] subsequently pushed legislative practices toward more centralization. The adaptation has not been easy, or automatic, or perhaps even adequate to the challenges; nonetheless, pressures toward centralized decision making have been relentless and powerful." Centralization carries with it the promise of stronger congressional leadership, which would make the job of White House lobbyists considerably easier. The House Democrats changed leaders in 1987 and the Senate Democrats will have a new leader in 1989. The new president thus may have new possibilities in legislative-executive relations.

Clearly the White House organization and its size will not remain static. They respond to political, technological, and institutional changes. Yet the new president would do well to start from the premise that small is still beautiful.

## *Disposing of Deadwood*

As he was about to take office, John Kennedy is supposed to have said to a friend, "I must make the appointments now. A year hence I will know who I really want to appoint." The implication is that a year hence he would also know who he wanted to fire. Yet presidents are notoriously bad at dismissing people. The inability to fire is almost a presidential trait. Why? It is not because presidents are uniquely kindhearted. Nor is it merely that they hate to admit mistakes. Nor even that they usually have had limited experience at firing people. It is because most of the people who become presidents have spent much of their lives seeking office, an activity in which not making enemies is important. More than calculation is involved: like Willie Loman, politicians want to be well-liked. The question, then, is how to get rid of unwanted appointees and remain popular. Indeed, the success of an administration can rest on finding the answer.

In some cases there is no answer. There was no way that Richard Nixon could have gracefully removed Watergate prosecutor Archibald Cox. In a few cases, a president will want to call deliberate attention to a dismissal, either because a dereliction of public trust is involved or as a warning to other appointees. In effect, the president is saying he will not tolerate certain kinds of behavior.

Most of the time, however, a president simply wants an unwanted appointee to go away without making a fuss. That happens more often than is usually noted. Every new administration has some members who ultimately realize that coming to Washington was a mistake and quietly take leave of the place. But what is the best way to get rid of those appointees who are highly visible, possibly have their own constituencies, good press contacts, and the potential to make trouble, and do not want to leave?

*"But what is the best way to get rid of those appointees who are highly visible, possibly have their own constituencies, good press contacts, and the potential to make trouble, and do not want to leave? Offer them another job."*

Offer them another job. From the president's vantage point, it is the *former* official, the insider who becomes the outsider, who could be dangerous.

Assume that the unwanted official is not untalented, merely in the wrong place — at least that is how the president must assess the situation. Finding the right place involves the fine art of equivalency, balancing the prestige of two positions — head of a domestic cabinet-level agency and a judgeship at the U.S. Court of Appeals level, for example.

Lyndon Johnson was the grand master at playing equivalency. Take the case of Robert McNamara. Johnson respected McNamara although the president was discomforted by his defense secretary's closeness to the Kennedys. By 1967 McNamara was uneasy with the president's Vietnam policy. As the presidential election year approached, LBJ surely was calculating the damage the Pentagon chief could cause if he resigned and made his objections to the war public, especially if Robert Kennedy decided to challenge Johnson for the Democratic nomination. So McNamara was offered and accepted the presidency of the World Bank. Not only had a potentially troubling political problem been finessed, but the World Bank had been placed in exceptionally capable hands. Two other persons left the Johnson cabinet for positions of



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relative equivalency. HEW Secretary Anthony Celebrezze, a former mayor of Cleveland, was made a federal judge, and Postmaster General John Gronouski, the first Polish-American to be in a president's cabinet, was appointed ambassador to Poland. (There is an added plus if the new job is out of Washington.)

Not all presidents, however, have played the equivalency game with such skill. Kennedy in wanting to remove Chester Bowles as under secretary of state and Nixon in wanting to remove Robert Finch as HEW secretary could not devise the appropriate equivalencies and ended up giving them nebulous White House assignments that fooled no one.

The difficulty that Donald Regan had in removing Margaret Heckler as secretary of health and human services attests to the heavy-handedness of President Reagan's chief of staff. But the inability to get rid of Regan in a neat and expeditious fashion was a near-fatal blow to that presidency. Had an equivalency been worked out, such as making Regan the ambassador extraordinary and plenipotentiary to the Court of St. James — a title likely to soothe a bruised ego — he would not have published his destructive account of life within the White House while Reagan was still in office. It is an object lesson in knowing when and how to fire unwanted officials.

## *Meeting the Press*

Says Jody Powell, President Carter's press secretary, "Almost every politician and press secretary learns that unless you plan carefully, unless you carefully control the flow of information, you end up getting your brains beat out." The best way for a first-year president to control the flow of information is to hold frequent full-dress televised press conferences. Ironically, that is exactly what the press says it wants.

Most discussions of the role of presidential press conferences include three common fallacies: that they are historically important, that they are journalistically important, and that they are breathtaking contests between reporters and president.

Woodrow Wilson, the 28th president, was the first to hold regular press conferences. Franklin Roosevelt, the 32nd president, should be given credit for inventing the modern press conference, although his answers were off the record unless he decreed otherwise. It could even be argued that John Kennedy, the 35th president, created the press conference as we now think of it because his meetings with the press were the first to be broadcast live. In sum, the history is short, and the formats and frequency have been so varied that a president can justify whatever he chooses to do on some grounds.

While the news conference has been called a critically important means of communication, journalistically it has a bad track record. It seldom makes news. If a president has something important to say, he can and does find far better vehicles than press conferences. Compare, for example, the news that comes from State-of-the-Union messages. The press conference, however, could be said to make important news if a president seriously misspeaks (which has happened only once, under Harry Truman, when he implied that the atomic bomb might be used against China during the Korean War), or if reporters, by their clever questioning, get the president to reveal information that he would have wanted to keep to himself. But any politician who has reached the rank of president knows how to duck, bob, and weave sufficiently to stay out of trouble. To put it bluntly, press conferences seldom produce much first-rate news.

Columnist William Rusher views press conferences as "metaphorical bullfights . . . . The president is the bull. The excitement stems from the tension over which of the major protagonists will triumph — the bull or the matador." Still, as George Reedy correctly points out, "The President has the advantage since he can make a quip, evade the question, decline to answer on grounds of national security or simply turn to another reporter. It's his news conference, not the media's." A president also can control the conference with an opening statement, by scripting answers to the expected questions, and even by planting questions with friendly reporters.

Nevertheless, sensible people are convinced that press conferences are high-stake gambles for a president. Questions often *sound* tough. Questioners often *sound* confrontational. Press conferences are also viewed as serious contests because reporters are constantly telling us that that is what they are — an impression that is good for business and for their egos. Yet when one reads the transcript of a press conference, what is asked and how easily it is parried produce a different reality.

The president, furthermore, has a great interest in perpetuating the notion that answering reporters' questions is a dangerous business. Assuming that the president in 1989 holds frequent press conferences, he will be applauded by the press for restoring "a critically important means of communication" and applauded by the public for having the guts to go into the bullring.

Since the presidency is always a compared-with-whom proposition, "frequent" probably means a press conference every other week. In that Reagan averaged six a year, this schedule would quadruple the meetings while only returning them to the Kennedy-Johnson level. The president might also take some secret satisfaction in knowing that such frequent news conferences would cost the three television networks approximately $114 million annually in lost prime-time revenues.

If press conferences are less significant than they have been pictured, why would holding them frequently in the president's first year be to his advantage? Largely because they fit so neatly into the fast-start strategy. Just as the public is forming its indelible image of the president, he steps into the televised bullring. At best, he "wins"; at worst, he does better than the previous bull.

Frequent presidential press conferences also downplay the role of the press secretary's daily briefing, which is to be fervently desired. The typical White House noon briefing



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*"Most discussions of the role of presidential press conferences include three common fallacies: that they are historically important, that they are journalistically important, and that they are breathtaking contests between reporters and president."*

has come to resemble an unruly fraternity party, where very little news of any value is produced. But when the reporters' next meeting with the president is never more than 13 days away, the press secretary's all-purpose reply should be "ask the president."

Post-Reagan press operations, in keeping with the principle of contrariness, can be expected to change in other ways following Larry Speakes' revelations that he invented presidential quotations. The press complains that it has problems getting accurate information. The White House complains that the press has problems covering the substance of policy. Both are right.

As the White House staff grows larger, it also grows more specialized. Presidential assistants, beyond the core of aides who directly advise the president, are increasingly economists, scientists, and other professional specialists. The White House press corps has also grown in size, but it is not any more specialized. It is a general assignments beat writ large. Even Sam Donaldson, the dean of White House TV reporters, only goes back to 1977, which should qualify him to be an expert on two presidents, but not necessarily on the presidency. Many reporters, such as Donaldson, get their White House assignment as a reward for covering the winning candidate during the campaign. News organizations use the change of presidents as an excuse to rotate reporters, thereby injecting mobility into their personnel systems.

The rationale is that campaign reporters make valuable contacts with the people who will become White House assistants — a dubious proposition because in Washington journalism, who you work for is more important than who you know. Short tenures also ensure that White House reporters are without a historical memory. (The wire services, who tend to treat the White House as a permanent assignment, are exceptions.) Moreover, these reporters are seldom experts in the substance of White House news; they are not specialists in foreign policy or economics or many of the other subjects that White House policy covers.

A president could always push news away from the White House press corps. The Treasury Department, rather than the White House, could announce major economic developments, for example. Reporters on that beat are better equipped to deal with issues of financial complexity. Specialized reportage has been noticeably upgraded in recent years, which suggests that an administration could receive more serious attention if it altered the loci of the information over which it has control. For most presidents, though, the thought of separating themselves from publicity is cruel and unusual punishment.

Since it is not within a president's power to reorganize the Washington news-gathering system or reassign reporters (although some have tried), the next best hope is to seek to educate the White House press corps. The president's science adviser might conduct weekly briefings on scientific matters that affect federal policy; the Council of Economic Advisers could do the same in its field; the Office of Management and Budget could conduct sessions on the intricacies of the budget process, just as it has done in the past for incoming White House staffs. This suggestion requires an additional criterion in the job descriptions of presidential advisers: the president's experts must be able to explain their expertise to the reporters whose job it is to explain the president's policies to their listeners and readers.

The White House must also decide how it wants to deal with the proliferation of local television news reportage from Washington. In 1979, when the first communications satellite went up, slightly more than 300 reporters covered Washington for local television stations; about the same number represented the networks. A decade later the "locals" have tripled in number and the "nationals" have remained the same. A new technology had created a growth industry in news-gathering. To date local TV stations are most interested in news of their congressional delegations. That need not always be the case. The temptation of presidents to reach voters through their local news shows — whose audiences are greater than the network news — must be considerable. But simply allowing in more cameras to cover an already well-covered presidential announcement or news conference is not likely to expand the president's audience. That usually requires the



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production of an entirely different kind of event, one that involves the presence of the president or the First Lady. Expanding this activity would soak up presidential time and should be resisted.

## *Living with Leaks*

Leaking, as defined in Washington, is the unauthorized giving of information to a journalist. The rules of the game are that the journalist must not identify the leaker and that the information must be sufficiently newsworthy that someone in government would not wish to have it publicly known at that time. Leaking, unlike the presidential press conference, has a long, and sometimes distinguished, history. Elie Abel, in a recent monograph on the subject, suggests that the first significant leak exposed a secret U.S. arms transaction with France. The year was 1778 and the leaker was Tom Paine.

Leaks, said President Ford, are a "real pain." They produce embarrassing news stories, throw off a president's timing, and consume an inordinate amount of high-level attention within the White House. If they get out of hand, they can lead to bad presidential management practices. With the threat of a leak hanging over his head like Damocles' sword, the president and his White House aides may unreasonably hurry a decision or severely limit the number of advisers who should be consulted or keep out technical experts who are not considered political loyalists. Donald Regan even claims that the "root of the [Iran-contra] scandal may well lie in the fact that [NSC heads Robert] McFarlane and [John] Poindexter and their assistants were, in a sense, driven mad by leaks . . . ." In short, the price paid for preventing leaks may far exceed the damage caused by unauthorized publication.

Ignoring leaks assumes, of course, that they are not important national security secrets. Government has a right to have secrets. Could the United States have reestablished relations with China if Henry Kissinger could not have carried on secret discussions with the Chinese? Doubtful. Advocates of free speech should not be cavalier about such concerns. Still, very few serious leaks have occurred, partly because the American press practices self-censorship in such cases, more often because the government is very good at keeping secret its real secrets.

President Reagan complained that leaks "reached a new high" in his administration. Some have argued that so many leaks occurred because Reagan brought into government so many ideologues willing to fight their battles through the media. If that argument is correct, then the solution for the next president is to choose staff of more temperate mien. But a Harvard study, published in 1986, found little correlation between leaking and ideology. The Reagan administration reached a record for leaks, just as the next administration will, because leaking has become such a routine and accepted part of Washington behavior and because as government gets more complex, more documents will be needed to produce decisions, more copying machines will be available to reproduce documents, and more reporters will be available to receive the documents.

So what advice might be useful to the new president? First, he should understand who is apt to be a leaker. Reagan's initial impulse was to blame bureaucrats. But it is a rare bureaucrat who engages in leaking. The civil servants' world faces inward. They know how to work within their own agency to thwart a president. In contrast, most journalists are outside their ken and represent risk beyond possible gain. Presidents also tend to blame leaks on their press officers. But the press office tries to avoid a practice that antagonizes the reporters who do not receive the leaks. The leakers, a president must be told, are his own political appointees.

Second, once the president understands who the leakers are, he can more readily accept the next proposition: a president is more leaked for than leaked against. That may not seem to be the case when he reads his morning paper, but it is true over a four- or eight-year balance sheet. When the president's side does the leaking, however, a leak is not a leak; it is a plant.

Third, as President Carter said, there is no "effective way to deal with the situation." Attempts to stop leakers, which usually involve wiretaps and lie detectors, are always painful, possibly illegal, rarely successful, and inevitably get a bad press.

The appropriate posture for a president, it seems to me, is to make a clear distinction between leaking and espionage. The latter is illegal and cannot be tolerated. Keep the classification of documents within reasonable bounds; do not tempt journalists by stamping "secret" unless the purpose is to get something in the press. Be prepared to make a case with editors for not publishing classified documents that they have acquired. Use cabinet and staff meetings to remind high-level appointees of their obligations in this regard. Consider personality as a factor in making top appointments (Secretary of State Alexander Haig and NSC Adviser Richard Allen were a tandem destined to produce leaks). Above all, have fortitude. As Kissinger said after he left government: "You see, most of the leaks — if you are philosophical about it — go away. I mean, they're unpleasant, but so what? If you ignore them, most of them are not of that huge significance."

## *A Final Word*

To be most useful, advice to a president-elect should fit a set of circumstances. Each election produces its own dynamic and helps shape what a president wishes to accomplish and what is politically feasible. Does the president win a narrow victory, similar to the contests of 1960 and 1968? Does he win in a landslide, as in 1932 and 1952? Does his party also win control of both houses of Congress? Of one house? Of no houses? In the course of the campaign, the president-elect incurs debts and obligations — to people, to groups, to policies. With such factors unknown as this is being written, advice must be partial and tentative in some respects. But there is one piece of advice to all presidents that is guaranteed: *Prepare to be surprised.*



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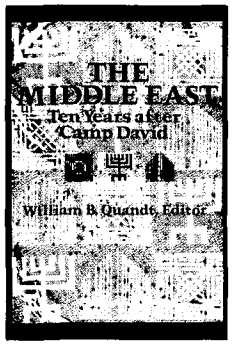
# *An Echo of the Past*




Ten years ago a framework for peace shaped by President Jimmy Carter was signed by Israeli Prime Minister Menachem Begin and Egyptian President Anwar Sadat at the presidential retreat near Washington, D.C., known as Camp David. Today the "spirit of Camp David" that pervaded the Middle East in the fall of 1978 exists largely in memory. Carter, Begin, and Sadat have departed. Palestinians are in revolt, and a diplomatic breakthrough is nowhere in sight. Egypt remains at peace with Israel, but it is a nervous peace clouded by anxiety and recurring mistrust.

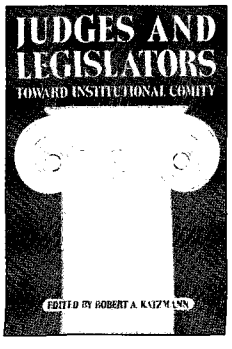
"The picture of the Middle East in 1988 could not have been painted by even the most prescient analyst when the Camp David Accords were signed a decade earlier," writes William B. Quandt, senior fellow in foreign policy studies at Brookings and editor of *The Middle East: Ten Years after Camp David.* Quandt was on the original negotiating team from the earliest stages through the signing of the Egyptian-Israeli peace treaty in March 1979. The Camp David legacy today represents "an echo of the past, not a model for the future," Quandt observes.

In their assessment of the effect of the accords on the Middle East, Quandt and the book's other contributors reached consensus on several broad themes, concluding, for example, that Egypt's decision to make peace with Israel was of major strategic importance to stability in the Middle East and that military power does not translate easily into attainment of political goals. In the concluding chapter, Brookings Visiting Fellow Harold H. Saunders recalls that the Camp David Accords resulted from extensive "shuttle mediation" and an unusual commitment by the Nixon, Ford, and Carter administrations. Saunders believes that treaties of the magnitude of Camp David can come only from political foundations built through efforts at understanding the needs of all parties.

***The Middle East: Ten Years after Camp David***

*Edited by William B. Quandt*
*$15.95 paper; $35.95 cloth*

# *Relations Between Courts and Congress*




In federal courtrooms across the nation, judges and lawyers ponder the same question with increasing frequency and growing frustration: What did Congress really intend when it wrote a particular law? On Capitol Hill, lawmakers look at opinions from federal benches and consider a different question: How did they dream up that interpretation? The result is a widening chasm between the federal judiciary and Congress, moving these two branches of government from a spirit of cooperation to one of confrontation.

In a new book, *Judges and Legislators: Toward Institutional Comity,* legal scholar and political scientist Robert A. Katzmann and other analysts explore the vexing misunderstanding that impedes the work of courts as

***Judges and Legislators: Toward Institutional Comity***

*Edited by Robert A. Katzmann*
*$10.95 paper; $28.95 cloth*



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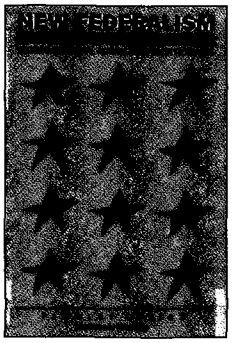
they operate within the confines of congressional statutes. At the heart of the matter is the lack of communication between the two branches. "If the executive and legislative branches were to cease regular communications," writes Katzmann, "the breakdown of government would be considered likely. That absence of communication between the judiciary and Congress should give equal cause for concern."

The book is part of a major project, undertaken at the invitation of the U.S. Judicial Conference Committee on the Judicial Branch, chaired by U.S. Circuit Judge Frank M. Coffin, himself a former member of Congress. In addition to Katzmann, a visiting fellow at Brookings, and Coffin, contributors include historians Maeva Marcus and Emily van Tassel, Rep. Robert W. Kastenmeier and his subcommittee counsel Michael Remington, political scientist Roger H. Davidson, Justice Hans Linde of the Oregon Supreme Court, and Patrick S. Atiyah, Oxford legal scholar.

# *A Study of Contrasts*

*New Federalism: Intergovernmental Reform from Nixon to Reagan*

*By Timothy Conlan*
*$15.95 paper; $34.95 cloth*



During the past 50 years, issues of federalism have repeatedly been at the center of domestic politics as cycles of federal expansion and political reaction have shaped the policy agenda. Viewed from this perspective, the bold "New Federalism" reforms proposed by Presidents Nixon and Reagan appear to be comparable attempts to decentralize power and restructure intergovernmental relationships on a grand scale.

Timothy Conlan offers an alternative perspective in this book, *New Federalism: Intergovernmental Reform from Nixon to Reagan.* Conlan identifies surprising differences in their goals and politics, differences that are important for understanding contemporary changes in conservative ideology and American politics.

Nixon's New Federalism constituted a coherent strategy to streamline an energetic government. Fully at ease with the concept of governmental activism, Nixon was mainly concerned with how to channel its energy and where to locate the wellsprings of initiative. Reagan, in contrast, used federalism reform initiatives as instruments of a broader effort to reduce the modern welfare state at every level of government.

Nixon's program was stymied and distorted by the fragmented politics of the 1970s. Reagan, on the other hand, was surprisingly effective in using instruments of national authority to decentralize responsibilities and to alter the national policy agenda. Conlan concludes with an examination of the Reagan legacy and its potential effects on intergovernmental relations. Conlan, who teaches at George Mason University, was formerly assistant staff director of the Senate Subcommittee on Intergovernmental Relations.



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The Institution was incorporated in 1927 to merge the Institute for Government Research, founded in 1916 as the first private organization devoted to public policy issues at the national level; the Institute of Economics, established in 1922 to study economic problems; and the Robert Brookings Graduate School of Economics and Government, organized in 1924 as a pioneering experiment in training for public service. The consolidated institution was named in honor of Robert Somers Brookings (1850–1932), a St. Louis businessman whose leadership shaped the earlier organizations.

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